PEABODY ENERGY CORP
Form 10-Q
November 04, 2011
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2011

or

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____________ to ____________

Commission File Number: 1-16463

PEABODY ENERGY CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	13-4004153
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
701 Market Street, St. Louis, Missouri	63101-1826
(Address of principal executive offices)	(Zip Code)

(314) 342-3400
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes (X) No ( )

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes (X) No ( )

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer (X)	Accelerated filer ( )	Non-accelerated filer ( )	Smaller reporting company ( )
		(Do not check if a smaller reporting company)	

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ( ) No (X)

There were 270,874,294 shares of common stock with a par value of $0.01 per share outstanding at October 28, 2011.

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PEABODY ENERGY CORPORATION
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in millions, except per share data)			
Revenues				
Sales	$1,737.3	$1,663.4	$5,151.8	$4,618.3
Other revenues	298.6	201.3	637.0	423.4
Total revenues	2,035.9	1,864.7	5,788.8	5,041.7
Costs and expenses				
Operating costs and expenses	1,458.8	1,243.3	4,119.7	3,526.7
Depreciation, depletion and amortization	113.7	116.7	327.8	327.3
Asset retirement obligation expense	15.0	9.9	43.9	30.3
Selling and administrative expenses	71.2	54.1	191.4	163.6
Other operating (income) loss:				
Net gain on disposal or exchange of assets	(1.7)	(6.7)	(31.4)	(15.4)
Loss (income) from equity affiliates	3.2	2.7	9.0	(2.1)
Operating profit	375.7	444.7	1,128.4	1,011.3
Interest expense	59.2	62.2	159.3	170.1
Interest income	(4.1)	(2.8)	(11.7)	(5.4)
Income from continuing operations before income taxes	320.6	385.3	980.8	846.6
Income tax provision	37.1	147.7	224.7	257.2
Income from continuing operations, net of income taxes	283.5	237.6	756.1	589.4
Loss from discontinued operations, net of income taxes	(2.0)	(1.3)	(3.7)	(2.2)
Net income	281.5	236.3	752.4	587.2
Less: Net income attributable to noncontrolling interests	7.4	12.2	17.0	23.2
Net income attributable to common stockholders	$274.1	$224.1	$735.4	$564.0
Income From Continuing Operations				
Basic earnings per share	$1.02	$0.84	$2.73	$2.11
Diluted earnings per share	$1.01	$0.83	$2.72	$2.09
Net Income Attributable to Common Stockholders				
Basic earnings per share	$1.01	$0.84	$2.72	$2.10
Diluted earnings per share	$1.00	$0.83	$2.71	$2.08
Dividends declared per share	$0.085	$0.070	$0.255	$0.210

See accompanying notes to unaudited condensed consolidated financial statements.

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PEABODY ENERGY CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited) September 30, 2011	December 31, 2010
	(Amounts in millions, except share and per share data)	
ASSETS		
Current assets		
Cash and cash equivalents	$1,401.6	$1,295.2
Accounts receivable, net of allowance for doubtful accounts of $23.3 at September 30, 2011 and $30.3 at December 31, 2010	591.4	558.2
Inventories	351.9	332.9
Assets from coal trading activities, net	66.0	192.5
Deferred income taxes	90.9	120.4
Other current assets	503.2	459.0
Total current assets	3,005.0	2,958.2
Property, plant, equipment and mine development		
Land and coal interests	7,841.3	7,657.0
Buildings and improvements	1,087.7	1,079.8
Machinery and equipment	2,175.8	1,699.3
Less: accumulated depreciation, depletion and amortization	(3,296.7)	(3,010.0)
Property, plant, equipment and mine development, net	7,808.1	7,426.1
Investments and other assets	878.5	978.8
Total assets	$11,691.6	$11,363.1
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities		
Current maturities of long-term debt	$43.8	$43.2
Liabilities from coal trading activities, net	62.6	181.7
Accounts payable and accrued expenses	1,334.9	1,288.8
Total current liabilities	1,441.3	1,513.7
Long-term debt, less current maturities	2,458.6	2,706.8
Deferred income taxes	499.6	539.8
Asset retirement obligations	537.3	501.3
Accrued postretirement benefit costs	965.6	963.9
Other noncurrent liabilities	466.7	448.3
Total liabilities	6,369.1	6,673.8
Stockholders’ equity		
Preferred Stock — $0.01 per share par value; 10,000,000 shares authorized, no shares issued or outstanding as of September 30, 2011 or December 31, 2010	—	—
Series A Junior Participating Preferred Stock — $0.01 per share par value; 1,500,000 shares authorized, no shares issued or outstanding as of September 30, 2011 or December 31, 2010	—	—

Perpetual Preferred Stock — 800,000 shares authorized, no shares issued or outstanding as of September 30, 2011 or December 31, 2010	—	—
Series Common Stock — $0.01 per share par value; 40,000,000 shares authorized, no shares issued or outstanding as of September 30, 2011 or December 31, 2010	—	—
Common Stock — $0.01 per share par value; 800,000,000 shares authorized, 279,986,117 shares issued and 270,818,478 shares outstanding as of September 30, 2011 and 279,149,028 shares issued and 270,236,256 shares outstanding as of December 31, 2010	2.8	2.8
Additional paid-in capital	2,231.3	2,182.0
Retained earnings	3,544.7	2,878.4
Accumulated other comprehensive loss	(139.1)	(67.9)
Treasury shares, at cost: 9,167,639 shares as of September 30, 2011 and 8,912,772 shares as of December 31, 2010	(350.7)	(334.6)
Peabody Energy Corporation’s stockholders’ equity	5,289.0	4,660.7
Noncontrolling interests	33.5	28.6
Total stockholders’ equity	5,322.5	4,689.3
Total liabilities and stockholders’ equity	$11,691.6	$11,363.1

See accompanying notes to unaudited condensed consolidated financial statements.

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PEABODY ENERGY CORPORATION
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30, 2011	2010
	(Dollars in millions)	
Cash Flows From Operating Activities		
Net income	$752.4	$587.2
Loss from discontinued operations, net of income taxes	3.7	2.2
Income from continuing operations, net of income taxes	756.1	589.4
Adjustments to reconcile income from continuing operations, net of income taxes to net cash provided by operating activities:		
Depreciation, depletion and amortization	327.8	327.3
Deferred income taxes	49.1	178.6
Share-based compensation	32.4	30.1
Net gain on disposal or exchange of assets	(31.4)	(15.4)
Loss (income) from equity affiliates	9.0	(2.1)
Changes in current assets and liabilities:		
Accounts receivable	(12.5)	(124.3)
Accounts receivable securitization program	—	(154.6)
Inventories	(17.5)	(71.2)
Net assets from coal trading activities	71.7	(0.8)
Other current assets	(41.6)	19.9
Accounts payable and accrued expenses	(8.6)	116.5
Asset retirement obligations	27.8	20.3
Workers’ compensation obligations	0.3	5.6
Pension costs	25.5	17.5
Accrued postretirement benefit costs	26.6	18.4
Contributions to pension plans	(1.3)	(23.9)
Other, net	(19.3)	(27.8)
Net cash provided by continuing operations	1,194.1	903.5
Net cash used in discontinued operations	(3.6)	(11.3)
Net cash provided by operating activities	1,190.5	892.2
Cash Flows From Investing Activities		
Additions to property, plant, equipment and mine development	(616.2)	(291.3)
Federal coal lease expenditures	(42.4)	—
Investment in Prairie State Energy Campus	(29.8)	(52.5)
Proceeds from disposal of assets	12.1	9.7
Investments in equity affiliates and joint ventures	(39.8)	(18.8)
Proceeds from sales of debt and equity securities	53.3	10.6
Purchases of debt and equity securities	(44.1)	(73.6)
Purchases of short-term investments	(100.0)	—
Maturity of short-term investments	100.0	—
Investment in shares of Macarthur Coal Limited	(45.5)	—
Other, net	(4.4)	(7.4)
Net cash used in investing activities	(756.8)	(423.3)
Cash Flows From Financing Activities		
Proceeds from long-term debt	1.4	1,150.0
Payments of long-term debt	(248.4)	(1,148.5)

Dividends paid	(69.1)	(56.5)
Repurchase of employee common stock relinquished for tax withholding	(16.1)	(8.4)
Payment of debt issuance costs	(4.0)	(32.2)
Excess tax benefits related to share-based compensation	6.1	—
Proceeds from stock options exercised	4.5	5.9
Other, net	(1.7)	(0.5)
Net cash used in financing activities	(327.3)	(90.2)
Net change in cash and cash equivalents	106.4	378.7
Cash and cash equivalents at beginning of period	1,295.2	988.8
Cash and cash equivalents at end of period	$1,401.6	$1,367.5

See accompanying notes to unaudited condensed consolidated financial statements.

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PEABODY ENERGY CORPORATION
UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	Peabody Energy Corporation's Stockholders' Equity						
	Common Stock	Additional Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interests	Total Stockholders' Equity
	(Dollars in millions)						
December 31, 2010	$2.8	$2,182.0	$(334.6)	$2,878.4	$ (67.9)	$ 28.6	$ 4,689.3
Comprehensive income:							
Net income	—	—	—	735.4	—	17.0	752.4
Net unrealized losses on available-for-sale securities (net of $2.3 tax benefit)	—	—	—	—	(4.3)	—	(4.3)
Decrease in fair value of cash flow hedges (net of $66.7 tax benefit)	—	—	—	—	(100.6)	—	(100.6)
Postretirement plans and workers' compensation obligations (net of $12.8 tax provision)	—	—	—	—	33.7	—	33.7
Comprehensive income				735.4	(71.2)	17.0	681.2
Dividends paid	—	—	—	(69.1)	—	—	(69.1)
Share-based compensation	—	32.4	—	—	—	—	32.4
Excess tax benefits related to share-based compensation	—	6.1	—	—	—	—	6.1
Stock options exercised	—	4.5	—	—	—	—	4.5
Employee stock purchases	—	6.3	—	—	—	—	6.3
Repurchase of employee common stock relinquished for tax withholding	—	—	(16.1)	—	—	—	(16.1)
Distributions to noncontrolling interests	—	—	—	—	—	(13.5)	(13.5)
Contributions from noncontrolling interests	—	—	—	—	—	1.4	1.4
September 30, 2011	$2.8	$2,231.3	$(350.7)	$3,544.7	$ (139.1)	$ 33.5	$ 5,322.5

See accompanying notes to unaudited condensed consolidated financial statements.

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PEABODY ENERGY CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The condensed consolidated financial statements include the accounts of Peabody Energy Corporation (the Company) and its affiliates. All intercompany transactions, profits and balances have been eliminated in consolidation.

The accompanying condensed consolidated financial statements as of September 30, 2011 and for the three and nine months ended September 30, 2011 and 2010, and the notes thereto, are unaudited. However, in the opinion of management, these financial statements reflect all normal, recurring adjustments necessary for a fair presentation of the results of the periods presented. The balance sheet information as of December 31, 2010 has been derived from the Company’s audited consolidated balance sheet. The results of operations for the three and nine months ended September 30, 2011 are not necessarily indicative of the results to be expected for future quarters or for the year ending December 31, 2011.

The Company classifies items within discontinued operations in the unaudited condensed consolidated statements of operations when the operations and cash flows of a particular component (defined as operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity) of the Company have been (or will be) eliminated from the ongoing operations of the Company as a result of a disposal transaction, and the Company will no longer have any significant continuing involvement in the operations of that component.

Certain amounts in prior periods have been reclassified to conform with the current year presentations with no effect on previously reported net income or stockholders’ equity.

(2) Newly Adopted Accounting Standards and Accounting Standards Not Yet Implemented

In June 2011, the Financial Accounting Standards Board (FASB) issued an accounting update that eliminates the option to present the components of other comprehensive income as part of the statement of shareholders’ equity. Instead, an entity will be required to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The guidance will become effective for interim and annual periods beginning after December 15, 2011, or on January 1, 2012 for the Company. Because the update only impacts financial statement presentation, the guidance will not impact the Company’s results of operations, financial condition or cash flows.

In January 2010, the FASB issued accounting guidance that required new fair value disclosures, including disclosures about significant transfers into and out of Level 1 and Level 2 fair-value measurements and a description of the reasons for the transfers. In addition, the guidance required new disclosures regarding activity in Level 3 fair value measurements, including a gross basis reconciliation. The Company began complying with the new fair value disclosure requirements beginning January 1, 2010, except for the disclosure of activity within Level 3 fair value measurements, which became effective January 1, 2011. While the adoption of this guidance had an impact on the Company's disclosures, it did not affect the Company's results of operations, financial condition or cash flows. In May 2011, the FASB issued additional fair value measurement disclosure requirements that were intended to provide a consistent definition of fair value and ensure that the fair value measurement and disclosure requirements are similar between United States (U.S.) generally accepted accounting principles (GAAP) and International Financial Reporting Standards. That update required the categorization by level for financial instruments not measured at fair value but for which disclosure of fair value is required, disclosure of all transfers between Level 1 and Level 2, and additional disclosures for Level 3 measurements regarding the sensitivity of fair value to changes in unobservable inputs and any interrelationships between those inputs. The guidance will become effective for interim and annual periods beginning after December 15, 2011, or on January 1, 2012 for the Company. The guidance issued in May 2011 will impact the Company's disclosures, but it will not impact the Company's results of operations, financial condition or cash flows.

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In December 2010, the FASB issued an update to guidance on accounting for business combinations that clarified a public entity's disclosure requirements for pro forma presentation of revenue and earnings related to a business combination. The new guidance, which became effective on January 1, 2011, requires that, if comparative statements are presented, the public entity should disclose revenue and earnings of the combined entity as though the business combination had occurred as of the beginning of the comparable prior annual reporting period only. The guidance also requires the supplemental pro forma disclosures to include a description of the nature and amount of material nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The guidance will impact the Company's pro forma disclosures related to any business combination transactions, but it will not impact the Company's results of operations, financial condition or cash flows.

(3) Investments

The Company's short-term investments are defined as those investments with original maturities of greater than three months and up to one year, and long-term investments are defined as those investments with original maturities greater than one year.

The Company classifies its investments as either held-to-maturity or available-for-sale at the time of purchase and reevaluates such designation periodically. Investments are classified as held-to-maturity when the Company has the intent and ability to hold the securities to maturity.

Investments in securities not classified as held-to-maturity are classified as available-for-sale. Available-for-sale securities are carried at fair value, with unrealized gains and losses, net of income taxes, reported in "Accumulated other comprehensive income (loss)" in the condensed consolidated balance sheets. Realized gains and losses, determined on a specific identification method, are included in "Interest income" in the unaudited condensed consolidated statements of operations.

The Company did not have any held-to-maturity securities as of September 30, 2011 or December 31, 2010.

Investments in available-for-sale securities at September 30, 2011 were as follows:

Available-for-sale securities	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in millions)			
Current:				
Federal government securities	$5.2	$—	$—	$5.2
U.S. corporate bonds	4.6	—	—	4.6
Noncurrent:				
Marketable equity securities	55.5	—	6.9	48.6
Federal government securities	11.4	0.2	—	11.6
U.S. corporate bonds	9.4	0.1	—	9.5
Total	$86.1	$0.3	$6.9	$79.5

Investments in available-for-sale securities at December 31, 2010 were as follows:

Available-for-sale securities	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(Dollars in millions)		
Current:				
Federal government securities	$0.5	$—	$—	$0.5
U.S. corporate bonds	1.9	—	—	1.9
Noncurrent:				
Federal government securities	9.2	—	—	9.2
U.S. corporate bonds	6.3	—	—	6.3
Total	$17.9	$—	$—	$17.9

Contractual maturities for available-for-sale investments in debt securities at September 30, 2011 were as shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Contractual maturities for available-for-sale securities	Cost	Fair Value
	(Dollars in millions)	
Due in one year or less	$9.8	$9.8
Due in one to five years	20.8	21.1
Total	$30.6	$30.9

The Company’s investments in marketable equity securities consists of an investment in Winsway Coking Coal Holdings Limited and shares purchased of Macarthur Coal Limited (Macarthur). For additional information on the Macarthur shares purchased, see Note 17.

Proceeds from sales of securities amounted to $1.5 million and realized gains on the sales amounted to $0.1 million for the three and nine months ended September 30, 2011.

In addition to the securities described above, the Company held investments in debt and equity securities related to the Company's pro-rata share of funding in the Newcastle Coal Infrastructure Group (NCIG). During the nine months ended September 30, 2011, the Company sold all of its interests in these debt and equity securities. New debt securities were purchased for the funding of the next phase of NCIG's port expansion during the three months ended September 30, 2011. These debt securities are recorded at cost, which approximates fair value, and are denominated in U.S. dollars. The fair value of these securities was $29.4 million at September 30, 2011.

At each reporting date, the Company performs separate evaluations of debt and equity securities to determine if any unrealized losses are other-than-temporary. None of the securities that were in an unrealized loss position at September 30, 2011 has been so for greater than 12 months. The Company did not recognize any other-than-temporary losses on any of its investments during the nine months ended September 30, 2011.

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(4) Inventories

Inventories consisted of the following:

	September 30, 2011	December 31, 2010
	(Dollars in millions)	
Materials and supplies	$ 109.8	$ 97.1
Raw coal	54.4	55.4
Saleable coal	187.7	180.4
Total	$ 351.9	$ 332.9

(5) Derivatives and Fair Value Measurements

Risk Management — Non-Coal Trading Activities

The Company is exposed to various types of risk in the normal course of business, including price risk on commodities utilized in the Company's operations, interest rate risk on long-term debt, and foreign currency exchange rate risk for non-U.S. dollar expenditures. In most cases, commodity price risk (excluding coal trading activities) related to the sale of coal is mitigated through the use of long-term, fixed-price contracts rather than through the use of financial instruments. For the price risk exposure on other commodities, as well as for the interest rate risk and foreign currency exchange rate risk, the Company utilizes financial derivative instruments to manage the risks related to these fluctuations. All of these risks are actively monitored in an effort to ensure compliance with the risk management policies of the Company.

Interest Rate Swaps. The Company is exposed to interest rate risk on its fixed rate and variable rate long-term debt. From time to time, the Company manages the interest rate risk associated with the fair value of its fixed rate borrowings using fixed-to-floating interest rate swaps to effectively convert a portion of the underlying cash flows on the debt into variable rate cash flows. The Company designates these swaps as fair value hedges, with the objective of hedging against changes in the fair value of the fixed rate debt that results from market interest rate changes. From time to time, the interest rate risk associated with the Company’s variable rate borrowings is managed using floating-to-fixed interest rate swaps. The Company designates these swaps as cash flow hedges, with the objective of reducing the variability of cash flows associated with market interest rate changes. As of September 30, 2011, the Company had no interest rate swaps in place.

Foreign Currency Hedges. The Company is exposed to foreign currency exchange rate risk, primarily on Australian dollar expenditures made in its Australian Mining segment. This risk is managed by entering into forward contracts and options that the Company designates as cash flow hedges, with the objective of reducing the variability of cash flows associated with forecasted foreign currency expenditures.

Diesel Fuel and Explosives Hedges. The Company is exposed to commodity price risk associated with diesel fuel and explosives in the U.S. and Australia. This risk is managed through the use of cost pass-through contracts and derivatives, primarily swaps. The Company generally designates the swap contracts as cash flow hedges, with the objective of reducing the variability of cash flows associated with forecasted diesel fuel and explosives purchases. In Australia, the explosives costs and a portion of the diesel fuel costs are not hedged as they are usually included in the fees paid to the Company’s contract miners.

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PEABODY ENERGY CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Notional Amounts and Fair Value. The following summarizes the Company’s foreign currency and commodity positions at September 30, 2011:

	Notional Amount by Year of Maturity						
	Total	2011	2012	2013	2014	2015	2016 and thereafter
Foreign Currency							
A$:US$ hedge contracts (A$ millions)	$3,977.9	$391.3	$1,605.5	$1,210.6	$770.5	$—	$—
GBP£:US$ hedge contracts (GBP millions)	£6.5	£—	£6.5	£—	£—	£—	£—
Commodity Contracts							
Diesel fuel hedge contracts (million gallons)	188.9	21.4	83.9	57.9	25.7	—	—
U.S. explosives hedge contracts (million MMBtu)	8.8	1.1	3.9	2.6	1.2	—	—

	Account Classification by			
	Cash Flow Hedge	Fair Value Hedge	Economic Hedge	Fair Value Asset (Liability) (Dollars in millions)
Foreign Currency				
A$:US$ hedge contracts (A$ millions)	$3,977.9	$—	$—	$412.5
GBP£:US$ hedge contracts (GBP millions)	£6.5	£—	£—	$(0.6)
Commodity Contracts				
Diesel fuel hedge contracts (million gallons)	188.9	—	—	$38.0
U.S. explosives hedge contracts (million MMBtu)	8.8	—	—	$(4.9)

Hedge Ineffectiveness. The Company assesses, both at inception and at least quarterly thereafter, whether the derivatives used in hedging activities are highly effective at offsetting the changes in the anticipated cash flows of the hedged item. The effective portion of the change in the fair value is recorded in “Accumulated other comprehensive loss” until the hedged transaction impacts reported earnings, at which time any gain or loss is reclassified to the consolidated statements of operations. To the extent that the periodic changes in the fair value of the derivatives exceed the changes in the hedged item, the ineffective portion of the periodic non-cash changes are recorded in the consolidated statements of operations in the period of the change. If the hedge ceases to qualify for hedge accounting, the Company prospectively recognizes the mark-to-market movements in the consolidated statements of operations in the period of the change.

A measure of ineffectiveness is inherent in hedging future diesel fuel purchases with derivative positions based on crude oil and refined petroleum products as a result of location and product differences.

The Company’s derivative positions for the hedging of future explosives purchases are based on natural gas, which is the primary price component of explosives. However, a small measure of ineffectiveness exists as the contractual purchase price includes manufacturing fees that are subject to periodic adjustments. In addition, other fees, such as transportation surcharges, can result in ineffectiveness, but have historically changed infrequently and comprise a small portion of the total explosives cost.

The Company’s derivative positions for the hedging of forecasted foreign currency expenditures contain a small measure of ineffectiveness due to timing differences between the hedge settlement and the purchase transaction, which could differ by less than a day and up to a maximum of 30 days.

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PEABODY ENERGY CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The tables below show the classification and amounts of pre-tax gains and losses related to the Company's non-trading hedges during the three and nine months ended September 30, 2011 and 2010:

		Three Months Ended September 30, 2011			
Financial Instrument	Statement of Operations Classification Gains (Losses) - Realized	Gain (loss) recognized in income on non-designated derivatives	Gain (loss) recognized in other comprehensive income on derivative (effective portion)	Gain (loss) reclassified from other comprehensive income into income (effective portion)	Gain (loss) reclassified from other comprehensive income into income (ineffective portion)
		(Dollars in millions)			
Diesel fuel cash flow hedge contracts	Operating costs and expenses	$—	$ (47.9)	$ 8.4	$ (1.0)
Explosives cash flow hedge contracts	Operating costs and expenses	—	(3.3)	0.1	(0.2)
Foreign currency cash flow hedge contracts:					
— Operating costs	Operating costs and expenses	—	(269.1)	92.2	—
— Capital expenditures	Depreciation, depletion and amortization	—	(0.5)	—	—
Total		$—	$ (320.8)	$ 100.7	$ (1.2)

		Three Months Ended September 30, 2010			
Financial Instrument	Statement of Operations Classification Gains (Losses) - Realized	Gain (loss) recognized in income on non-designated derivatives	Gain (loss) recognized in other comprehensive income on derivative (effective portion)	Gain (loss) reclassified from other comprehensive income into income (effective portion)	Gain (loss) reclassified from other comprehensive income into income (ineffective portion)
		(Dollars in millions)			
Diesel fuel cash flow hedge contracts	Operating costs and expenses	$—	$ 22.3	$ (10.9)	$ 0.7
Explosives cash flow hedge contracts	Operating costs and expenses	—	(1.1)	(2.5)	—
Foreign currency cash flow hedge contracts	Operating costs and expenses	—	434.7	38.5	—
Total		$—	$ 455.9	$ 25.1	$ 0.7

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PEABODY ENERGY CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

		Nine Months Ended September 30, 2011			
Financial Instrument	Statement of Operations Classification Gains (Losses) - Realized	Gain (loss) recognized in income on non-designated derivatives	Gain (loss) recognized in other comprehensive income on derivative (effective portion)	Gain (loss) reclassified from other comprehensive income into income (effective portion)	Gain (loss) reclassified from other comprehensive income into income (ineffective portion)
		(Dollars in millions)			
Diesel fuel cash flow hedge contracts	Operating costs and expenses	$—	$ 25.0	$ 28.4	$ 1.1
Explosives cash flow hedge contracts	Operating costs and expenses	—	(4.1)	—	(0.7)
Foreign currency cash flow hedge contracts:					
— Operating costs	Operating costs and expenses	—	33.8	261.1	—
— Capital expenditures	Depreciation, depletion and amortization	—	(0.7)	—	—
Total		$—	$ 54.0	$ 289.5	$ 0.4

		Nine Months Ended September 30, 2010			
Financial Instrument	Statement of Operations Classification Gains (Losses) - Realized	Gain (loss) recognized in income on non-designated derivatives[1]	Gain (loss) recognized in other comprehensive income on derivative (effective portion)	Gain (loss) reclassified from other comprehensive income into income (effective portion)	Gain (loss) reclassified from other comprehensive income into income (ineffective portion)
		(Dollars in millions)			
Interest rate swaps cash flow hedge contracts	Interest expense	$(8.5)	$ 0.8	$ (0.5)	$ —
Diesel fuel cash flow hedge contracts	Operating costs and expenses	—	(7.5)	(27.3)	—
Explosives cash flow hedge contracts	Operating costs and expenses	—	(4.7)	(7.4)	—
Foreign currency cash flow hedge contracts	Operating costs and expenses	—	355.3	104.4	—
Total		$(8.5)	$ 343.9	$ 69.2	$ —

(1) Amounts relate to swaps that were de-designated and terminated in conjunction with the refinancing of the Company's previous credit facility.

Based on the net fair value of the Company's non-coal trading positions held in "Accumulated other comprehensive loss" at September 30, 2011, unrealized gains to be reclassified from comprehensive income to earnings over the next 12 months associated with the Company's foreign currency and diesel fuel hedge programs are expected to be approximately $230 million and $36 million, respectively. The unrealized losses to be realized under the explosives hedge program are expected to be approximately $3 million. As these unrealized gains are associated with derivative instruments that represent hedges of forecasted transactions, the amounts reclassified to earnings will partially offset the realized transactions, while the unrealized losses will add incremental expense to the condensed consolidated statements of operations.

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PEABODY ENERGY CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The classification and amount of derivatives presented on a gross basis as of September 30, 2011 and December 31, 2010 are as follows:

	Fair Value as of September 30, 2011			
Financial Instrument	Current Assets	Noncurrent Assets	Current Liabilities	Noncurrent Liabilities
	(Dollars in millions)			
Diesel fuel cash flow hedge contracts	$37.1	$14.3	$1.1	$12.3
Explosives cash flow hedge contracts	—	—	3.1	1.8
Foreign currency cash flow hedge contracts	243.2	203.2	13.0	21.5
Total	$280.3	$217.5	$17.2	$35.6

	Fair Value as of December 31, 2010			
Financial Instrument	Current Assets	Noncurrent Assets	Current Liabilities	Noncurrent Liabilities
	(Dollars in millions)			
Diesel fuel cash flow hedge contracts	$25.3	$26.9	$11.9	$—
Explosives cash flow hedge contracts	0.5	0.1	0.1	0.6
Foreign currency cash flow hedge contracts	273.5	366.6	—	—
Total	$299.3	$393.6	$12.0	$0.6

After netting by counterparty where permitted, the fair values of the respective derivatives are reflected in “Other current assets,” “Investments and other assets,” “Accounts payable and accrued expenses” and “Other noncurrent liabilities” in the condensed consolidated balance sheets.

See Note 6 for information related to the Company’s coal trading activities.

Fair Value Measurements

The Company uses a three-level fair value hierarchy that categorizes assets and liabilities measured at fair value based on the observability of the inputs utilized in the valuation. These levels include: Level 1, inputs are quoted prices in active markets for the identical assets or liabilities; Level 2, inputs other than quoted prices included in Level 1 that are directly or indirectly observable through market-corroborated inputs; and Level 3, inputs are unobservable, or observable but cannot be market-corroborated, requiring the Company to make assumptions about pricing by market participants.

Financial Instruments Measured on a Recurring Basis. The following tables set forth the hierarchy of the Company’s net financial asset (liability) positions for which fair value is measured on a recurring basis:

	September 30, 2011			
	Level 1	Level 2	Level 3	Total
	(Dollars in millions)			
Investment in debt and equity securities	$79.5	$—	$—	$79.5
Commodity swaps and options — diesel fuel	—	38.0	—	38.0
Commodity swaps and options — explosives	—	(4.9)	—	(4.9)
Foreign currency hedge contracts	—	411.9	—	411.9
Total net financial assets	$79.5	$445.0	$—	$524.5

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PEABODY ENERGY CORPORATION
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	December 31, 2010			
	Level 1	Level 2	Level 3	Total
	(Dollars in millions)			
Investment in debt securities	$17.9	$—	$—	$17.9
Commodity swaps and options — diesel fuel	—	40.3	—	40.3
Commodity swaps and options — explosives	—	(0.1)	—	(0.1)
Foreign currency hedge contracts	—	640.1	—	640.1
Total net financial assets	$17.9	$680.3	$—	$698.2

For Level 1 and 2 financial assets and liabilities, the Company utilizes both direct and indirect observable price quotes, including interest rate yield curves, exchange indices, broker quotes, published indices and other market quotes. Below is a summary of the Company's valuation techniques for Level 1 and 2 financial assets and liabilities:

- Investment in debt and equity securities: valued based on quoted prices in active markets (Level 1).
- Commodity swaps and options — diesel fuel and explosives: generally based on a valuation that is corroborated by the use of market-based pricing (Level 2).
- Foreign currency hedge contracts: valued utilizing inputs obtained in quoted public markets (Level 2).

The Company did not have any transfers between levels during the three or nine months ended September 30, 2011 or 2010 for its non-coal trading positions. The Company's policy is to value all transfers between levels using the beginning of period valuation.

Other Financial Instruments. The following methods and assumptions were used by the Company in estimating fair values for other financial instruments as of September 30, 2011 and December 31, 2010:

- Cash and cash equivalents, accounts receivable, including those within the Company's accounts receivable securitization program, and accounts payable and accrued expenses have carrying values which approximate fair value due to the short maturity or the liquid nature of these instruments.
- The Company's investments in debt and equity securities related to the Company's pro-rata share of funding in NCIG are included in "Investments and other assets" in the condensed consolidated balance sheets. The debt securities are recorded at cost, which approximates fair value.
- Long-term debt fair value estimates are based on observed prices for securities with an active trading market when available, and otherwise on estimated borrowing rates to discount the cash flows to their present value. The carrying amounts of the 7.875% Senior Notes due 2026 and the Convertible Junior Subordinated Debentures due 2066 (the Debentures) are net of the respective unamortized note discounts.

The carrying amounts and estimated fair values of the Company's debt are summarized as follows:

	September 30, 2011		December 31, 2010	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
	(Dollars in millions)			
Long-term debt	$2,502.4	$2,645.3	$2,750.0	$2,960.0

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Nonperformance and Credit Risk

The fair value of the Company's non-coal trading derivative assets and liabilities reflects adjustments for nonperformance and credit risk. The Company manages its counterparty risk through established credit standards, diversification of counterparties, utilizing investment grade commercial banks and continuous monitoring of counterparty creditworthiness. To reduce its credit exposure for these hedging activities, the Company seeks to enter into netting agreements with counterparties that permit the Company to offset asset and liability positions with such counterparties.

(6) Coal Trading

Risk Management

The Company engages in direct and brokered trading of coal, ocean freight and fuel-related commodities in over-the-counter markets (coal trading), some of which is subsequently exchange-cleared and some of which is bilaterally-settled. Except those for which the Company has elected to apply a normal purchases and normal sales exception, all derivative coal trading contracts are accounted for on a fair value basis.

The Company's policy is to include instruments associated with coal trading transactions as a part of its trading book. Trading revenues are recorded in "Other revenues" in the unaudited condensed consolidated statements of operations and include realized and unrealized gains and losses on derivative instruments, including coal deliveries related to contracts accounted for under the normal purchases and normal sales exception. Therefore, the Company has elected the trading exemption to reflect the disclosures for its coal trading activities.

	Three Months Ended September 30,		Nine Months Ended September 30,	
Trading Revenues by Type of Instrument	2011	2010	2011	2010
	(Dollars in millions)			
Commodity swaps and options	$(0.6)	$38.9	$(26.6)	$29.5
Physical commodity purchase/sale contracts	29.6	23.2	60.9	141.5
Total trading revenues	$29.0	$62.1	$34.3	$171.0

Hedge Ineffectiveness. The Company assesses, both at inception and at least quarterly thereafter, whether the derivatives used in hedging activities are highly effective at offsetting the changes in the anticipated cash flows of the hedged item. The effective portion of the change in the fair value is recorded in "Accumulated other comprehensive loss" until the hedged transaction impacts reported earnings, at which time gains and losses are reclassified to the unaudited consolidated statements of operations at the time of the recognition of the underlying hedged item. To the extent that the periodic changes in the fair value of the derivatives exceed the changes in the hedged item, the ineffective portion of the periodic non-cash changes are recorded in the unaudited consolidated statements of operations in the period of the change. If the hedge ceases to qualify for hedge accounting, the Company prospectively recognizes the mark-to-market movements in the unaudited consolidated statements of operations in the period of the change.

In some instances, the Company has designated an existing coal trading derivative as a hedge and, thus, the derivative has a non-zero fair value at hedge inception. The "off-market" nature of these derivatives, which is best described as an embedded financing element within the derivative, is a source of ineffectiveness. In other instances, the Company uses a coal trading derivative that settles at a different time, has different quality specifications, or has a different location basis than the occurrence of the cash flow being hedged. These collectively yield ineffectiveness to the extent that the derivative hedge contract does not exactly offset changes in the fair value or expected cash flows of the hedged item.

Forecasted Transactions No Longer Probable. During the nine months ended September 30, 2011, the Company reclassified losses of $9.1 million out of "Accumulated other comprehensive loss" to earnings as the underlying forecasted transactions were deemed no longer probable of occurring.

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Fair Value Measurements

The fair value of assets and liabilities from coal trading activities is set forth below:

	September 30, 2011		December 31, 2010	
	Gross Basis	Net Basis	Gross Basis	Net Basis
	(Dollars in millions)			
Assets from coal trading activities	$590.5	$66.0	$1,706.2	$192.5
Liabilities from coal trading activities	(660.5)	(62.6)	(1,843.5)	(181.7)
Subtotal	(70.0)	3.4	(137.3)	10.8
Net margin posted [1]	73.4	—	148.1	—
Net value of coal trading positions	$3.4	$3.4	$10.8	$10.8

(1) Represents margin posted with counterparties and exchanges of $73.4 million at September 30, 2011; and margin posted with counterparties and exchanges of $148.2 million, net of margin held of $0.1 million, at December 31, 2010. In addition, at December 31, 2010, the Company held letters of credit of $5.0 million from counterparties in lieu of margin posted. Of the margin posted at September 30, 2011, approximately 94% related to cash flow hedges.

The Company's trading assets and liabilities are generally made up of forward contracts, financial swaps and margin. The fair value of coal trading positions, before the application of margin, designated as cash flow hedges of anticipated future sales was a liability of $109.5 million and $174.2 million as of September 30, 2011 and December 31, 2010, respectively.

The following tables set forth the hierarchy of the Company's net financial asset (liability) coal trading positions for which fair value is measured on a recurring basis:

	September 30, 2011			
	Level 1	Level 2	Level 3	Total
	(Dollars in millions)			
Commodity swaps and options	$15.1	$3.9	$—	$19.0
Physical commodity purchase/sale contracts	—	(23.8)	8.2	(15.6)
Total net financial assets (liabilities)	$15.1	$(19.9)	$8.2	$3.4

	December 31, 2010			
	Level 1	Level 2	Level 3	Total
	(Dollars in millions)			
Commodity swaps and options	$10.7	$(76.2)	$—	$(65.5)
Physical commodity purchase/sale contracts	—	57.7	18.6	76.3
Total net financial assets (liabilities)	$10.7	$(18.5)	$18.6	$10.8

For Level 1 and 2 financial assets and liabilities, the Company utilizes both direct and indirect observable price quotes, including U.S. interest rate curves, LIBOR yield curves, Chicago Mercantile Exchange (CME), New York Mercantile Exchange (NYMEX), Intercontinental Exchange indices (ICE), NOS Clearing ASA, LCH.Clearnet (formerly known as the London Clearing House), Singapore Exchange (SGX), broker quotes, published indices and other market quotes. Below is a summary of the Company's valuation techniques for Level 1 and 2 financial assets and liabilities:

- Commodity swaps and options — generally valued based on unadjusted quoted prices in active markets (Level 1) or a valuation that is corroborated by the use of market-based pricing (Level 2).
- Physical commodity purchase/sale contracts — purchases and sales at locations with significant market activity corroborated by market-based information (Level 2).

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Commodity swaps and options and physical commodity purchase/sale contracts transacted in less liquid markets or contracts, such as long-term arrangements with limited price availability, were classified in Level 3. Indicators of less liquid markets are those with periods of low trade activity or when broker quotes reflect wide pricing spreads. Generally, the Company's Level 3 instruments or contracts are valued using internally generated models that include bid/ask price quotations, other market assessments obtained from multiple, independent third-party brokers or other transactional data. While the Company does not anticipate any decrease in the number of third-party brokers or market liquidity, such events could erode the quality of market information and therefore the valuing of its market positions should the number of third-party brokers decrease or if market liquidity is reduced. The Company's valuation techniques also include basis adjustments for heat rate, sulfur and ash content, port and freight costs and credit and nonperformance risk. The Company validates its valuation inputs with third-party information and settlement prices from other sources where available. The Company has consistently applied these valuation techniques in all periods presented, and believes it has obtained the most accurate information available for the types of derivative contracts held.

The following table summarizes the changes in the Company's recurring Level 3 net financial assets:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in millions)			
Beginning of period	$9.9	$13.8	$18.6	$17.0
Total gains (losses) realized/unrealized:				
Included in earnings	(1.4)	2.1	10.7	(0.6)
Included in other comprehensive income	—	0.2	—	0.3
Settlements	(1.3)	(0.7)	(3.1)	(1.4)
Transfers in (out)	1.0	0.8	(18.0)	0.9
End of period	$8.2	$16.2	$8.2	$16.2

The following table summarizes the changes in unrealized gains (losses) relating to Level 3 net financial assets held both as of the beginning and the end of the period:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in millions)			
Changes in unrealized gains (losses) (1)	$(1.1)	$1.2	$8.7	$3.5

(1) Within the unaudited condensed consolidated statements of operations for the periods presented, unrealized gains and losses from Level 3 items are combined with unrealized gains and losses on positions classified in Level 1 or 2, as well as other positions that have been realized during the applicable periods.

The Company did not have any significant transfers between Level 1 and Level 2 during the three or nine months ended September 30, 2011 or 2010. During the nine months ended September 30, 2011, certain of the Company's physical commodity purchase/sale contracts were transferred from Level 3 to Level 2 as the settlement dates entered a more liquid market. There were no significant transfers in or out of Level 3 during the three or nine months ended September 30, 2010. The Company's policy is to value all transfers between levels using the beginning of period valuation.

Based on the net fair value of the Company's coal trading positions held in "Accumulated other comprehensive loss" at September 30, 2011, unrealized losses to be reclassified from comprehensive income to earnings over the next 12 months are expected to be approximately $76 million. As these unrealized losses are associated with derivative instruments that represent hedges of forecasted transactions, the amounts reclassified to earnings may partially offset the realized transactions in the unaudited condensed consolidated statements of operations.

As of September 30, 2011, the timing of the estimated future realization of the value of the Company's trading portfolio was as follows:

Year of Expiration	Percentage of Portfolio Total
2011	33%
2012	46%
2013	9%
2014	8%
2015	4%
	100%

Nonperformance and Credit Risk. The fair value of the Company's coal derivative assets and liabilities reflects adjustments for nonperformance and credit risk. The Company's exposure is substantially with electric utilities, steel producers, energy marketers and energy producers. The Company's policy is to independently evaluate each customer's creditworthiness prior to entering into transactions and to regularly monitor the credit extended. If the Company engages in a transaction with a counterparty that does not meet its credit standards, the Company seeks to protect its position by requiring the counterparty to provide an appropriate credit enhancement. Also, when appropriate (as determined by its credit management function), the Company has taken steps to reduce its exposure to customers or counterparties whose credit has deteriorated and who may pose a higher risk of failure to perform under their contractual obligations. These steps include obtaining letters of credit or cash collateral (margin), requiring prepayments for shipments or the creation of customer trust accounts held for the Company's benefit to serve as collateral in the event of a failure to pay or perform. To reduce its credit exposure related to trading and brokerage activities, the Company seeks to enter into netting agreements with counterparties that permit the Company to offset asset and liability positions with such counterparties and, to the extent required, will post or receive margin amounts associated with exchange-cleared positions.

At September 30, 2011, 35% of the Company's credit exposure related to coal trading activities was with investment grade counterparties while 54% was with non-investment grade counterparties and 11% was with counterparties that are not rated.

Performance Assurances and Collateral. Certain of the Company's derivative trading instruments require the parties to provide additional performance assurances whenever a material adverse event jeopardizes one party's ability to perform under the instrument. If the Company was to sustain a material adverse event (using commercially reasonable standards), the counterparties could request collateralization on derivative trading instruments in net liability positions which, based on an aggregate fair value at September 30, 2011 and December 31, 2010, would have amounted to collateral postings of approximately $48 million and $160 million, respectively, to its counterparties. As of September 30, 2011, $1.0 million of collateral was posted to counterparties for such positions while $5.8 million was posted at December 31, 2010 (reflected in "Liabilities from coal trading activities, net").

Certain of the Company's other derivative trading instruments require the parties to provide additional performance assurances whenever a credit downgrade occurs below a certain level as specified in each underlying contract. The terms of such derivative trading instruments typically require additional collateralization, which is commensurate with the severity of the credit downgrade. If a credit downgrade were to have occurred below contractually specified levels, the Company's additional collateral requirement owed to its counterparties would have been approximately $2 million at September 30, 2011 and zero at December 31, 2010 based on the aggregate fair value of all derivative trading instruments with such features that were in a net liability position. As of September 30, 2011, the Company had zero posted for such instruments in a net liability position. As of December 31, 2010, $5.0 million of margin was posted with a counterparty due to timing and market fluctuations (reflected in "Liabilities from coal trading activities, net").

The Company is required by an exchange to post certain collateral, known as initial margin, which represents an estimate of potential future adverse price movements across the Company's portfolio under normal market conditions. As of September 30, 2011 and December 31, 2010, the Company had posted initial margin of $58.9 million and $39.5 million, respectively (reflected in "Other current assets"). In addition, the Company had posted $13.0 million and $4.4 million of margin in excess of the exchange-required variation (discussed below) and initial margin as of September 30, 2011 and December 31, 2010, respectively (also reflected in "Other current assets").

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The Company is required to post collateral on positions that are in a net liability position with an exchange, known as variation margin, which was $72.4 million as of September 30, 2011 and $137.4 million as of December 31, 2010 (reflected in “Liabilities from coal trading activities, net”).

(7) Income Taxes

The following is a reconciliation of the expected statutory federal income tax provision to the Company’s actual income tax provision:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Dollars in millions)			
Expected income tax provision at federal statutory rate	$112.2	$134.9	$343.3	$296.3
Excess depletion	(13.9)	(25.8)	(39.0)	(44.4)
Foreign earnings provision differential	(34.9)	(29.8)	(84.5)	