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Board of Directors and Stockholder
Kaiser Coal Corporation
Colorado Springs, Colorado

We have examined the consolidated balance sheet of Kaiser Coal Corporation (a wholly-owned subsidiary of Kaiser Steel Corporation) and subsidiaries as of December 31, 1985, and the related statements of income, stockholder's equity and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the consolidated financial statements referred to above present fairly the financial position of Kaiser Coal Corporation and subsidiaries as of December 31, 1985, and the results of their operations and changes in their financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year, except for the changes, with which we concur, as described in Note 2 of the financial statements.

Touche Ross & Co.

Certified Public Accountants

Los Angeles, California
March 27, 1986

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10-K 1986 3rd quarter
pending

KAISER COAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

DECEMBER 31, 1985
(Amounts in thousands)

ASSETS

CURRENT ASSETS:	
Cash (including temporary investments of $1,400)	$ 259
Accounts receivable - trade	10,805
Accounts receivable - affiliate	333
Inventories (Notes 2 and 3)	8,121
Mine development - current (Note 2)	7,165
Other	1,391
Total current assets	28,074
PROPERTY, PLANT AND EQUIPMENT, net (Notes 4 and 5)	323,752
WATER RIGHTS AND OTHER ASSETS	15,636
MINE DEVELOPMENT - long-term (Note 2)	6,143
	$373,605

LIABILITIES AND STOCKHOLDER'S EQUITY

CURRENT LIABILITIES:	
Accounts payable	$ 9,370
Accounts payable to Kaiser Steel Corporation	1,228
Accrued salaries and benefits	4,886
Current portion of long-term debt (Note 5)	1,816
Current portion of long-term debt - Chase Manhattan Bank (Note 5)	6,000
Other	2,180
Total current liabilities	25,480
LONG-TERM DEBT (Note 5)	11,492
LONG-TERM DEBT - Chase (Note 5)	51,000
ACCRUED MEDICAL, BLACK LUNG, WORKERS' COMPENSATION AND OTHER BENEFITS	20,634
Total liabilities	108,606
COMMITMENTS AND CONTINGENCIES (Note 6)	
STOCKHOLDER'S EQUITY (Note 1):	
Common stock, $1 par value; 10,000 shares authorized; 1,000 shares issued and outstanding (Note 5)	1
Paid-in capital	255,786
Retained earnings	9,212
Total stockholder's equity	264,999
	$373,605

See notes to consolidated financial statements.

KAISER COAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INCOME

YEAR ENDED DECEMBER 31, 1985
(Amounts in thousands)

REVENUES	$92,619
COST OF SALES	65,781
	26,838
OPERATING EXPENSES:	
Management and brokerage fees (Note 5)	4,632
Depreciation and depletion	7,419
SPS Royalties	510
Other	2,540
Total operating expenses	15,101
OPERATING PROFIT	11,737
OTHER EXPENSES:	
Interest expense	5,227
Kaiser Steel management fee	1,070
Other	(31)
Total other expenses	6,266
INCOME BEFORE CUMULATIVE EFFECT ON PRIOR YEARS OF ACCOUNTING CHANGES	5,471
CUMULATIVE EFFECT ON PRIOR YEARS OF ACCOUNTING CHANGES (Note 2)	3,741
NET INCOME	$ 9,212

See notes to consolidated financial statements.

KAISER COAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDER'S EQUITY

YEAR ENDED DECEMBER 31, 1985
(Amounts in thousands)

	Common stock	Paid-in capital	Retained earnings	Total
BALANCE, January 1, 1985 (Note 1)	$1	$315,786	$ -	$315,787
Net income			9,212	9,212
Dividend paid to Kaiser Steel Corporation	—	(60,000)	—	(60,000)
BALANCE, December 31, 1985	$1	$255,786	$9,212	$264,999

See notes to consolidated financial statements.

KAISER COAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

YEAR ENDED DECEMBER 31, 1985
(Amounts in thousands)

SOURCES OF WORKING CAPITAL:	
Income before cumulative effect of accounting changes	$ 5,471
Add - expenses not using working capital:	
Depreciation and depletion	7,419
	12,890
Working capital provided by operations	
Other sources of working capital:	
Cumulative effect on prior years of accounting changes	3,741
Additions to long-term debt - Chase	60,000
Additions to long-term debt	11,469
Additions to medical, black lung and workers' compensation benefits liabilities, net	442
	88,542
USES OF WORKING CAPITAL:	
Dividends to Kaiser Steel	60,000
Additions to property, plant and equipment, net	11,976
Additions to mine development - long-term	6,143
Additions to water rights and other assets	2,201
Payments and current maturities on long-term debt - Chase	9,000
Payments and current maturities on long-term debt	1,901
Payment of medical, black lung and workers' compensation benefits	684
	91,905
DECREASE IN WORKING CAPITAL	($ 3,363)
CHANGES IN COMPONENTS OF WORKING CAPITAL:	
Increase in current assets:	
Cash	$ 259
Accounts receivable	933
Inventories	5,669
Mine development - current	7,165
Other	443
	14,469
Increase in current liabilities:	
Accounts payable	8,474
Accrued salaries and benefits	776
Current portion of long-term debt	1,303
Current portion of long-term debt - Chase	6,000
Other	1,279
	17,832
DECREASE IN WORKING CAPITAL	($ 3,363)

See notes to consolidated financial statements.

KAISER COAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1985

Note 1 - Summary of Significant Accounting Policies:

Basis of Presentation

On April 2, 1985, Kaiser Steel Corporation ("Kaiser Steel") transferred its Utah and New Mexico coal properties to Kaiser Coal Corporation ("Kaiser Coal"), a wholly-owned subsidiary which had been formed on January 7, 1985. The facilities and equipment of the operating mines in Utah and New Mexico were in turn transferred to two subsidiaries of Kaiser Coal, Kaiser Coal Corporation of Sunnyside and Kaiser Coal Corporation of York Canyon. All of the transfers were recorded at book value at December 31, 1984 and the related divisional equity was capitalized as paid in capital. The book values reflect the fair valuing of the assets and liabilities as of December 31, 1983 as part of a quasi-reorganization and subsequent merger of Kaiser Steel Corporation and Kaiser Acquisition Corporation which was accounted for as a purchase. These financial statements give effect to the transfers as if they had taken place on January 1, 1985.

Principles of Consolidation

The consolidated financial statements include the accounts of Kaiser Coal Corporation and its wholly-owned subsidiaries. Intercompany transactions and accounts have been eliminated. There were no sales to affiliated entities during 1985.

Inventories

Inventories are carried at the lower of last-in, first-out (LIFO) cost or market.

Property, Plant and Equipment

Coal properties, water rights, machinery, equipment, buildings and structures are recorded at cost. All items are depreciated over their estimated lives on a units-of-production basis. Depletion of coal properties is calculated based on a units-of-production method.

Accrued Medical, Black Lung, Workers' Compensation and Other Benefits

The estimated liability to both active and retired Kaiser Coal employees who have vested interests in Kaiser Steel Corporation's medical benefits plan has been recorded in the balance sheet. An accrual has been made for amounts expected to be paid to employees in the form of black lung benefits and for amounts expected to be paid in workers' compensation benefits or insurance premiums, and for amounts expected to be paid for other benefits.

KAISER COAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1985

(Continued)

Income Taxes

Kaiser Coal is included in the consolidated income tax return of Kaiser Steel. No provisions for current or deferred income taxes have been made in the consolidated financial statements because of the operating losses of the consolidated group and the inability to carryback any of the consolidated group's losses to prior years. Future utilizations of financial statement net operating loss carryforwards will be credited to paid-in capital in accordance with the accounting rules applicable to quasi-reorganizations.

Pension and Profit-sharing Plan

Kaiser Coal employees are included in Kaiser Steel's pension and profit-sharing plans which cover substantially all employees. Contributions to the defined benefit pension plan are actuarially determined to include amounts necessary to provide for current employee service and the funding of prior service liabilities over periods of up to 40 years. Kaiser Steel also maintains a salaried employees' Savings and Profit-sharing Plan. Contributions to the plan are based in part on earnings. Contributions to these plans are recorded as expenses (Note 6).

Note 2 - Changes in Accounting Principles:

During 1985, the Company changed its method of accounting for certain coal mine inventories and development costs to more closely associate costs with revenues. Prior to 1985, the Company directly expensed all costs associated with the generation of pit inventories at its York Canyon surface mine and all costs associated with the development of submain entries and longwall panels at its underground mines as such costs were incurred. Pit inventories are now recognized as the coal is uncovered and the costs of generating pit inventories are allocated to the coal expected to be removed based upon engineering data. The costs incurred during the development of submain entries and longwall panels to expose unmined reserves are now capitalized as preproduction costs and allocated to cost of sales as coal is produced on a units-of-production method based upon coal expected to be recovered as determined by engineering data.

As a result of the changes in accounting principles, the income before the cumulative effect on prior years of the accounting changes was increased by $12.8 million during 1985. In addition, the cumulative effect on prior years of the accounting changes increased 1985 net income by $3.7 million. It is not practicable to determine the pro forma effect of the changes on individual prior years.

KAISER COAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1985

(Continued)

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As a result of the changes in accounting principles, the income before the cumulative effect on prior years of the accounting changes was increased by $12.8 million during 1985. In addition, the cumulative effect on prior years of the accounting changes increased 1985 net income by $3.7 million. It is not practicable to determine the pro forma effect of the changes on individual prior years.

KAISER COAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1985

(Continued)

Commencing during the second quarter of 1985, the Company extended the estimated useful lives of certain coal mine equipment based upon historical data and engineering studies. The effect of this change was to increase net income by $3.6 million in 1985.

Note 3 - Inventories:

Inventories consist of the following:

	(thousands)
Parts and supplies	$3,013
Semi-finished and finished products	5,108
	$8,121

Note 4 - Property, Plant and Equipment:

Property, plant and equipment consists of:

	(thousands)
Coal reserves, land and land development	$254,360
Machinery and equipment	72,366
Buildings and structures	11,036
Construction in progress	1,198
Total	338,960
Less accumulated depreciation and depletion	15,208
Property, plant and equipment, net	$323,752

In December 1985, Kaiser Coal completed the acquisition of a coal mine complex near Paonia, Colorado and a coal preparation plant near Price, Utah from U.S. Steel Corporation and U.S. Steel Mining Co., Inc. Concurrently, the Company entered into a contract to supply the coal requirements of the U.S. Steel Corporation's Geneva Steel Mill. The Company expects to supply 750,000 to 800,000 tons of coal per year through 1989 under this contract. The acquired mine complex near Paonia, Colorado contains an estimated 60 million recoverable tons of high BTU, low ash, low sulfur coal on fee lands. The mine, which was idled prior to the acquisition, also includes mining equipment and a unit train loadout. The

KAISER COAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1985

(Continued)

coal wash plant has a capacity of two million tons of clean coal per year. Due to its proximity to existing coal properties, this acquisition effectively doubles the clean coal capacity in Utah. The principal terms of the purchase called for $100,000 in cash and an $8.9 million note, payable in equal quarterly principal installments of $222,500 with interest accruing at the rate of prime plus one percent. In the event that U.S. Steel terminates the coal supply contract prior to December 30, 1988 any unpaid quarterly principal payments from the date of termination until December 30, 1988 shall be deemed as paid. The loan agreement contains various financial and other covenants similar to The Chase Manhattan Bank (National Association) ("Chase"), debt agreement detailed in Note 5.

Note 5 - Long-term Debt:

Long-term debt consists of various notes bearing interest from 10.79% to 14.00% collateralized by property, plant and equipment and due at various dates in 1986 through 1995.

Long-term debt - Chase consists of amounts due under a $60 million long-term credit agreement with Chase, dated March 28, 1985. The loan is payable over ten years in quarterly installments of $1.5 million; however, under certain conditions, based on coal shipments and defined cash flows, the quarterly payment may be reduced to $750,000. The difference between the actual payment and $1.5 million must be made up in subsequent quarters. The loan bears interest at 1.5% above the bank's prime commercial lending rate or the CD rate plus 3.5%. The loan is collateralized by the common stock of Kaiser Coal and its operating subsidiaries, substantially all of Kaiser Coal and its operating subsidiaries' property, plant and equipment and coal reserves, and assignment of all coal sales contracts.

The loan agreement contains various financial and other covenants relating to Kaiser Coal, including covenants pertaining to working capital and capital expenditures. Payment of dividends to Kaiser Steel is dependent upon meeting certain cash flow requirements as specified in the loan agreement.

Expected principal payments on all notes for future years are as follows:

	(thousands)
1986	$ 7,989
1987	7,864
1988	7,874
1989	8,035
1990	6,955
Subsequent years	31,591
	$70,308

KAISER COAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1985

(Continued)

Note 6 - Commitments and Contingencies:

Certain mining equipment is leased under operating lease agreements.

Minimum payments under these agreements, which expire in 1986 through 1991, are as follows:

	(thousands)
1986	$ 3,614
1987	3,416
1988	3,795
1989	3,780
1990	2,425
Thereafter	1,371
	$18,401

Rent expense was $2,228 for 1985.

Kaiser Coal also leases certain coal properties which require advance minimum royalty payments of $1,410,000 each year through 2004. The advance minimum royalty payments are to be credited against production royalties of 4% of gross coal sales from the properties, once production begins. Until production begins, these advance minimum royalty payments are recorded as other assets.

Kaiser Steel has substantial unfunded pension liabilities. Under the requirements of ERISA, KCC as a subsidiary of Kaiser Steel, may be liable for a portion of the unfunded liabilities of the consolidated group should Kaiser Steel at some future date be unable to meets its obligations.

Note 7 - Transactions with Related Parties:

On March 28, 1985, Kaiser Coal entered into a coal brokerage agreement with Perma Mining Corporation ("Perma Mining"), an affiliate of Kaiser Steel's parent company, to market its coal. Perma Mining receives 3% of gross coal sales as its brokerage fee. Management Services Agreements were executed on March 28, 1985 by Perma Mining and each of Kaiser Coal's operating subsidiaries - Kaiser Coal Corporation of York Canyon and Kaiser Coal Corporation of Sunnyside. Perma Mining receives 2% of gross coal sales as its management fee. Fees of $4,632,000 were paid to Perma Mining in 1985 related to these agreements.

Each of the three agreements provide for an initial term of 15 years.

KAISER COAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEAR ENDED DECEMBER 31, 1985

(Continued)

During 1985, Kaiser Coal paid to Kaiser Steel $1,070,000 for management services performed by the parent company. The fee charged is based upon one percent of planned coal sales.

Prior to the merger, described in Note 1, the Perma Group, an affiliate of Kaiser Steel's parent, entered into an agreement with Southwestern Public Service Company ("SPS") pursuant to which SPS would enter into a long-term supply contract for the purchase of coal beginning in 1990. This agreement was subsequently contributed to Kaiser Steel as part of an exchange of assets in April, 1985. The long-term supply contract was for the supply of coal to SPS' planned electric power generating facility which was to be constructed in Texas. During 1985, SPS' Notice of Intent to construct the power generating facility was denied. Kaiser Steel is presently negotiating with SPS with respect to changes in the agreements with SPS due to the denial. Under the agreement, SPS receives a one percent overriding royalty on coal sales from the New Mexico coal reserves and, has an option to acquire a ten percent interest in the coal properties located in New Mexico and Colorado (owned by Kaiser Steel) for $10 million. In 1985, royalties of $510,000 were paid to SPS.

Note 8 - Major Customers:

During 1985, sales to three unaffiliated customers amounted to $17,343,000, $12,577,000 and $10,461,000 or 18.7%, 13.6% and 11.3%, respectively, of the Company's net revenues.

Note 9 - Subsequent Events:

On January 31, 1986 Kaiser Coal entered into a one-year $6,000,000 working capital loan with The Chase Manhattan Bank (National Association). The loan is collateralized by the accounts receivable from sales of coal. Draws, repayments and redraws must be made in multiples of $120,000 and interest accrues on the loan at prime plus 1.5% on any outstanding balance.

In January 1986, Kaiser Steel and KCC entered into an agreement with Association Southern Investment Company ("ASIC"), a subsidiary of Southern California Edison, under which Kaiser Steel has an option to sell certain real proprty in San Bernardino County, California, to ASIC. If this option is exercised and ASIC acquires the property, ASIC has the right to exchange such property for a percentage interest in KCC's New Mexico coal properties and Kaiser Steel's Colorado coal properties equal to $15 million divided by the appraised fair market value of the coal properties.