QUEENSLAND RESOURCES COUNCIL

STATE OF THE SECTOR

JUNE QUARTER 09 EDITION 2

VOLUME 1 NUMBER 2

GLOBAL ECONOMIC SLOWDOWN BITES

BY MICHAEL ROCHE, CHIEF EXECUTIVE

Welcome to the second edition of QRC's *State of the Sector Report.* Importantly, it's also our first edition with the QRC's unique CEO Sentiment Index included.

Representing the views of the QRC's full-member company CEOs, the index tells us the extent to which a number of core issues are likely to impact upon the economic, environmental and social objectives of the Queensland resources sector over the next 12 months.

It is perhaps no surprise that the number-one issue keeping the sector's CEOs awake at night is the global macroeconomic environment.

The sharp deterioration in global economic conditions has had a significant impact on resource demand and prices. The pace and severity of the deterioration has been significant and the short-term outlook, regrettably, remains uncertain.

There are however some indications that the economic downturn might be beginning to stabilise. For example, renewed enthusiasm in some coal markets was experienced in June, and prices for some base and precious metals rebounded slightly.

Despite this, global economic activity is expected to continue to be weak during 2009 and possibly into 2010.

Against the backdrop of higher costs and intensifying global competition, the priority for resource companies will be to weather this storm, and in doing so, continue to look for efficiencies in their operations and new market opportunities.

The number-two issue for CEOs at the moment is the proposed Carbon Pollution Reduction Scheme (CPRS). The Queensland coal and black coal electricity generation sectors will be particularly disadvantaged by this scheme.

Under the current proposal, the Australian coal industry will pay approximately $15 billion in carbon costs over the next 10 years.

However, and despite being eligible for approximately $9 billion in free permits as transitional assistance, the Australian Government will instead return the industry a mere $750 million over the first five years under the proposed Climate Change Action Fund.

This multi-billion dollar carbon liability will have a significant impact on the Australian coal industry.

Modelling demonstrates that premature shutdowns and cut backs in production are likely, and new investment will be discouraged. More information on this issue is outlined in our feature piece—*The Carbon Pollution Reduction Scheme—Impacts on the Queensland coal industry.*

Queensland's black coal electricity generators will also be severely disadvantaged. Under the CPRS, the current formula for the Electricity Sector Adjustment Scheme (ESAS) will provide the black coal generation fleet with a disproportionately low level of compensation.

Despite estimates that the CPRS will impose a $3 billion direct asset loss on the Queensland fleet over its remaining life, the ESAS will allow for only $100 million in assistance out of a total $3.5 billion. This compares with $2.45 billion of assistance likely to be provided to Victoria's brown coal generators, which are considerably more carbon emissions-intensive than Queensland's black coal generators.

The QRC believes this sends a perverse message about the environmental outcomes the CPRS is designed to achieve.

In short, very high domestic carbon costs, coupled with expectations of strong future global demand for resources will lead to Queensland jobs being lost offshore, most likely to countries with poorer environmental controls than ours.

With the CPRS legislation yet to be passed, the QRC continues to work hard with our national colleagues to bring about changes. Furthermore, we encourage communities and the hard workers of this sector to voice their concerns to their parliamentarians.

IN THIS EDITION:

• Key indicators: QRC Production and Price Indexes

• Feature: The Carbon Pollution Reduction Scheme—impacts on the Queensland coal industry

• Industry sentiment: The QRC CEO Sentiment Index

FEATURE: THE CARBON POLLUTION REDUCTION SCHEME—IMPACTS ON THE QUEENSLAND COAL INDUSTRY

The Australian Government is committed to an Emissions Trading Scheme (ETS) as the main policy instrument for achieving a national greenhouse gas emissions reduction target of between 5 and 25 percent of 2000 levels by 2020.

Planned to start from 1 July 2011, the scheme will require entities that have direct emissions of 25,000 tonnes of CO_2-e a year or more to acquire a permit for every tonne of greenhouse gas that they emit.

To put this into context, a small Queensland coal mine, employing approximately 200 people, and producing 3.5 million tonnes of coal per year, emitted 300,000 tonnes of CO_2-e per year in 2008. Emissions are mainly in the form of fugitives (ie methane from the coal seam), diesel and electricity consumption.

At the end of each year, each liable entity will need to surrender a permit for every tonne of direct emissions that they produced in that year.

Compared with current and proposed ETS schemes around the world, the Australian ETS is unique and onerous in that it will require emitting industries to purchase through auction 70 to 75 percent of its net permits from the outset of the scheme.

Alternatively, other countries with an ETS have never auctioned more than two percent of their permits, and the proposed Waxman-Markey legislation, which recently passed the United States House of Representatives, proposes only 15–18 percent auctioning over the first decade.

This is recognition that high carbon costs will damage those industries that are 'trade exposed', are 'price takers' in global markets and can't pass costs on and, who compete against countries with no such carbon costs.

Under the CPRS, and until such time global competitors face comparable carbon costs, firms whose emissions intensity threshold is greater than 1000 tonnes of CO_2-e per million dollars of revenue will receive transitional assistance from government via an allocation of 66 percent free permits in the first year, or if emissions are greater than 2000 tonnes of CO_2-e per million of revenue, 94.5 percent free permits.

In place for 10 years, and subject to review after five, the transitional assistance will not stay at these levels after year one, but will be reduced at 1.3 percent per annum. Further, the carbon price and cost of permits will increase over time as tighter abatement targets are set by the Australian Government.

The issue for the coal industry is that it has been treated unfairly by being excluded from this assistance despite being eligible. It is estimated that the 'trade-exposed' Australian coal industry will incur approximately $15 billion in carbon costs over the first 10 years of the CPRS.This is despite having an emissions intensity threshold of 1330 tonnes of CO_2-e per million of revenue, making it eligible for approximately $9 billion in (free permit) transitional assistance over 10 years. The government will instead return to the industry a mere $750 million over five years as assistance.

As companies receiving transitional assistance will still need to purchase a significant and increasing quantum of more expensive carbon permits over time, receiving this assistance will not remove the incentive to offset these costs and to abate.

In lieu of a comprehensive global agreement, reducing greenhouse gases without creating carbon leakage (where production moves offshore to countries with limited incentives to abate) will rely on carbon policies that create incentives to abate.

To this end, carbon liabilities should not be so high that abatement initiatives cannot be afforded, and worse, that compromise the financial viability of the firm.

Further, the timing of carbon liabilities needs to be aligned with the availability of technological options.

As the table below demonstrates, few technological options currently exist to abate coal mining greenhouse gases, and options that might be available will take significant periods to implement.

Carbon source	Reduction leadtime (yrs)	How
Measurement of fugitives	3	600 measurement points across all mine sites
Underground rich methane	5	20mw expansion of existing power stations for $50-100m capital cost
Underground vent air methane	7	installation of 20 voxidisers for over $200m capital cost
Fuel	10+	No technology retrofit-300 piece fleet to retrofit
Power	10+	No technology available
Fugitive open-cut	10+	No technology available

Abatement Options for Anglo Coal Australia – extract from a speech by Seamus French, CEO, AngloCoal to the Minerals Council of Australia June 2009.

Four separately commissioned economic reports demonstrate that the CPRS as proposed will contribute to coal mining output, employment, and royalties falling in the years 2020 and 2030 when compared to a 'business as usual' scenario.

This is because the emergence of a global emissions price will cause changes in global demand, and domestically the CPRS will cause a number of current operations to either shutdown prematurely or scale back production. In addition, future investment in new operations will be discouraged.

THE QRC PRODUCTION INDEX

The QRC Production Index is a weighted index that tracks percentage increases and decreases in the total production of Queensland bauxite, alumina, aluminium, coal (all saleable), copper, gold, lead, silver, zinc, oil, gas, and electricity (NEM) quarter to quarter.

The QRC Production Index at the end of the March 2009 quarter (latest available data) reached 99 index points (June 2005/06 = 100).

Compared to the December 2008 quarter, this represents a 14 percent decrease in output of Queensland's main resources. In dollar terms, this represents a $5.2 billion decrease in the value of production.

Approximately $4 billion of this decrease was on account on lower coal sales, predominantly metallurgical coal.

Metallurgical coal is used to make steel. The global economic recession and lower levels of consumer spending on steel-intensive manufactured goods such as motor vehicles and appliances, as well as reduced construction activity in countries such as the United States, Japan and Europe, are the main reasons for this marked decrease.

Significant decreases in production and value of production were also recorded for copper (down $219 million), lead (down $89 million), silver (down $47 million), and zinc (down $65 million). This is a direct consequence of several mine closures as well as the closure of the Mount Isa to Townsville railway line for a number of weeks following the heavy rains in February.

The demand outlook for resources looks uncertain but generally positive. For example, in the period April–June 2009, companies reported stronger coal sales to a number of markets, notably China, Brazil and Europe.

Medium-term demand growth is projected to be strong, underpinned by strong rates of economic growth in developing Asian countries as these economies experience strong population growth, urbanisation and growth in industrial production.

THE QRC PRICE INDEX

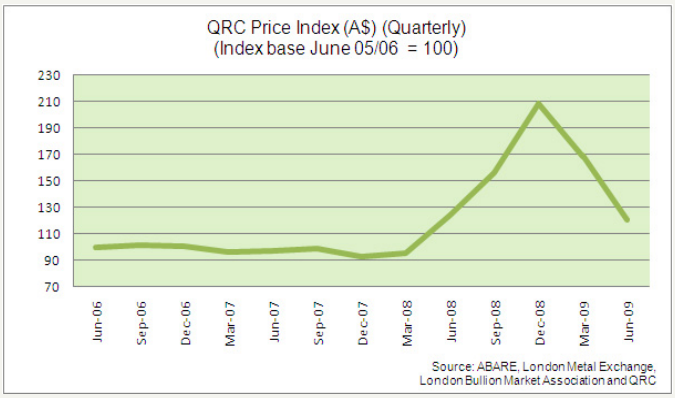
Comprising the same basket of goods as the QRC Production Index, the QRC Price Index to the June 2009 quarter reached 119 index points (June 2005/06 = 100).

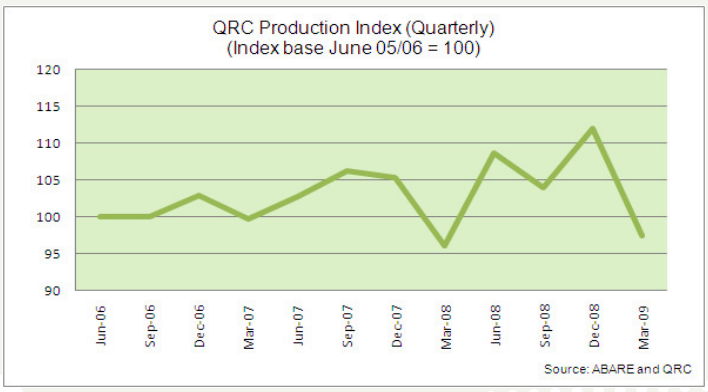
Compared to the March 2009 quarter, this represents a 47 percent decrease in prices across Queensland's main resources. This comprises a significant fall in coal prices; slight increases in spot prices for aluminium, copper, lead, and zinc; and slight decreases for gold, alumina, and silver.

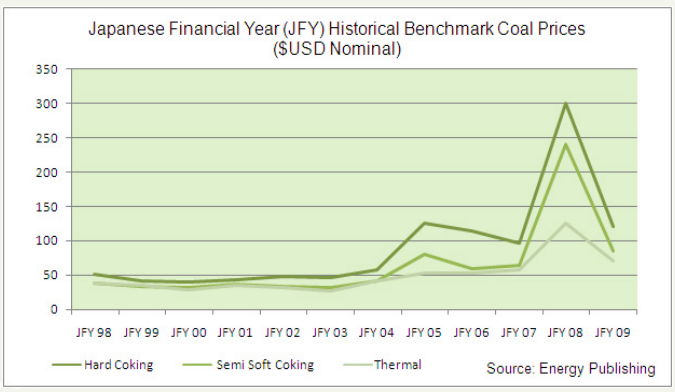
The majority of Australia's thermal and metallurgical coal trade is conducted on a contract basis and based on the Japanese financial year (JFY), April to March. Thermal coal contracts for the 2009 JFY were settled in the US$70-72 per tonne range, a decrease of approximately 44 percent on the record levels of the previous year.

Coking coal (hard) contracts for the 2009 JFY were settled in the US$115-130 per tonne range, a decline of approximately 60 percent on the record levels of the previous year. Prices for semi-soft coking coal and PCI are expected to settle around the US$80 and US$87 per tonne mark respectively. Of note is that these prices have settled back to long-term trend, as shown in the chart below.

Despite a 13 percent appreciation in the Australian dollar (relative to the US dollar) between the March and June 2009 quarters, slight price increases were recorded for aluminium (A$1,963t to A$2,058t), copper (A$5,513t to A$6,584t), lead (A$1,821t to A$2,231t) and zinc (A$1,788t to A$2,079t).







QUEENSLAND RESOURCES COUNCIL
LEVEL 13, 133 MARY ST, BRISBANE QLD 4000
T (07) 3295 9560 F (07) 3295 9570 E INFO@QRC.ORG.AU WWW.QRC.ORG.AU

- *The employment effects in the Australian minerals industry from the proposed carbon pollution reduction scheme in Australia* commissioned for the Australian minerals industry by Concept Economics (May 2009)
- Reports 1 and 2 commissioned for the Council for the Australian Federation Secretariat (the State and Territory Governments) by Access Economics (May 2009)
- *Economic assessment of CPRS' treatment of coal mining* commissioned for the Australian coal industry by ACIL Tasman (May 2009)
- *CPRS Impacts on EITE Mining/Processing Activities* commissioned for the QRC by ACIL Tasman (November 2008)

These reports can be accessed at http://www.qrc.org.au and go to publications.

QRC CEO SENTIMENT INDEX

The QRC CEO Sentiment Index is a survey of the QRC's 79 full-member company chief executives.

These companies cover the majority of mining, minerals processing, contracting, exploration, electricity generation and oil and gas extraction activities in Queensland.

CEOs on 10 June 2009 were asked: *Answering 'not at all', 'less than normal', 'same', 'more than normal', or 'very strongly', to what degree will the following adversely impact upon the economic, environmental, and social objectives of your organisation over the next 12 months?*

The macroeconomic environment	High input costs	Difficulty in raising capital
Difficulty in accessing global markets	Difficulty in attracting and retaining skilled employees	Social licence to operate pressures
Domestic climate change policies	Domestic workplace relations policies	Hard infrastructure availability
Soft infrastructue availability	Uncertain and/or poor regulation	

The responses are collated and weighted with each issue receiving a unique index scoring. A score between 0-20 indicates 'not at all', 20-40 'less than normal', 40-60 'same', 60-80 'more than normal', and 80-100 'very strongly'.

Summary of key findings June Quarter 2009
In priority order, issues that will 'very strongly' and 'more than normal' impact on the Queensland resources sector over the next 12 months are:

1 The global economic environment (uncertainty in relation to when global recovery will occur and future demand and price levels) (score 75)

2 Domestic climate change policies (concerns in relation to the very high costs coupled with few abatement options and negligible transitional assistance) (score 68)

3 Uncertain and/or poor regulation (concerns in relation to land access, namely future policies regarding the mining of more closely settled lands and compensation of landholders when exploration occurs; sovereign risk associated with royalty changes; Native Title processes; review of the Queensland Mining Safety and Health Act; increasingly anomalous position in relation to the continued prohibition on uranium mining; and increasing environmental regulations) (score 64)

4 Domestic workplace relations policies (uncertainty in relation to future third-party influence; increased costs emanating from the award modernisation process and the new unfair dismissal laws; and ensuring adequate flexibility in agreement making) (score 63)

5 Difficulty in raising capital (high-risk premiums and greater prudential controls by lenders; and capital remains expensive and scarce) (score 62)

6 Hard infrastructure availability (concerns re access and performance following the proposed privatisation of Queensland's export related assets; and inherent inefficiencies in export transport chains due to competing interests) (score 60)

7 High input costs (concerns in relation to the cumulative impact of greater regulatory imposts) (score 60)

QRC PROFILE

The Queensland Resources Council is the peak representative body for almost 160 companies with interests in the state's minerals and energy sector. The QRC's 79 full-member companies comprise explorere, miners, contractors, mineral processors, oil and gas producers and electricity generators. QRC service companies cover the gamut of professional services provided to the resources sector in the four corners of Queensland.

Written and prepared by the QRC. The data for this publication is sourced from a number of public sources–notably the Australian Bureau of Agricultural and Resource Economics and the Australian Bureau of Statistics. For more information, contact the QRC on (07) 3295 9560 or http://qrc.org.au