

QRC STATE OF THE SECTOR

JUNE QUARTER 2015

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QRC CEO **Sentiment** Index

CERTAINTY DEFICIT TAKES SHINE OFF SMART BUDGET



By Michael Roche, Chief Executive Queensland Resources Council

Queensland Treasurer Curtis Pitt's first budget was notable for delivering on the government's pre-election commitment to royalty stability and resisting clawback through other taxes, fees and charges.

I have said that the government was making smart use of the state's financial assets, and it was no glib remark. It was informed by being deeply involved in the preparation of around 10 federal and state budgets and by taking the trouble to read Queensland Treasury's [2015 Review of State Finances](#).

With both sides of politics eschewing a privatisation strategy to repair the state's finances, the ALP's debt reduction strategy is a good Plan B. Having funded election promises in this budget, the Treasurer has to keep a lid on his colleagues' enthusiasm for extravagant new spending in future budgets.

Leading into the budget we were told there would be a collapse in royalty revenues but what we found was Treasury budgeting for royalties to grow in 2015-16 – and keep growing.

In calculating likely coal royalty revenues, they sensibly adopted some realistic and achievable price assumptions for the year ahead, coupled to a conservative exchange rate assumption.

Treasury is forecasting a steady \$1.68 billion in coal royalties this financial year, but their outlook also reflects the start of the long-term budget dividend from development of an export gas industry, growing to more than \$500 million a year in royalties by 2018-19. Treasury has for the first time published oil price assumptions underlying gas royalty projections.

Queensland's often forgotten minerals and metals sector keeps delivering, with a budgeted royalty contribution of \$463 million, up from \$392 million in 2014-15.

While the government is working towards a State Infrastructure Plan in early 2016, we were not alone in expressing some disappointment in the lack of clear evidence of the government's preparedness to take a more active role with important enabling infrastructure (see this edition's feature article).

One year ahead of schedule, the budget delivered regional Queensland the first instalment of its Building our Regions program, with \$55 million over the next two years for a Royalties for Resource Producing Communities Fund.

Given the heavy backlog of critical community infrastructure (e.g. water and sewerage) and strong political interest in FIFO issues, the government of the day has to ensure that these communities are attractive places for people to work and live.

One unappealing aspect of a 'Jobs Now' budget was \$20 million over five years to develop an 'economic transition strategy' for the supposed phasing out of sand mining on North Stradbroke Island by 2019.

QRC will keep asking the government how a five-year \$20 million strategy can hope to replace about 270 mine jobs, hundreds more contractor positions and the injection by sand mining of \$130 million a year into the Island's economy. As it stands, it's a sure-fired recipe for a social and economic disaster and must be reconsidered.

In line with an election commitment, the government also felt obliged to rush through legislation that condemns 300 Darling Downs locals and another 160 contractors employed at the New Acland mine to months more uncertainty about their future job security.

The mine runs out of coal in 2017 but the repeal of some sensible LNP reforms will mean that the Land Court will be forced to hear objections to the Coordinator-General's conditions on the job preserving and job expanding New Acland Stage 3 project, even though under the law the Land Court cannot make any recommendations about those conditions. QRC's focus will now be to advocate for some strict timeframes on future Land Court handling of such objections.

It's instructive in relation to these two cases that this quarter's QRC CEO Sentiment Index recorded big spikes in negative sentiment towards 'business certainty/regulation' and 'social licence', with the former perhaps an early warning sign to the new government and the latter further confirmation of the real business impacts of the campaigns of the anti-resources activists.

On the upside, while some have rushed to declare the end of sector investment in Queensland, I have been asserting my belief that we would – governments and courts willing – see final investment decisions on more coal, minerals and gas projects over the next 12 months.

Testing this forecast through supplementary questions in this quarter's Sentiment Index, we learned of nine companies looking closely at greenfield investment opportunities.

Eleven more are moving to replace existing capacity while another three are looking to expand existing operations. The bulk of these projects involve capital expenditure of up to \$500 million each, which collectively represents a multi-billion dollar boost to the state's economy.



KEY INDICATORS

QRC PRODUCTION INDEX

QRC's quarterly production index tracks changes in the total production of Queensland's resources* –alumina, aluminium, bauxite, coal, copper, gold, lead, silver, and zinc. The index is weighted by the value of production. This means changes in the volume of coking coal produced (more than 50% of the value of Queensland resources production) has a proportionately larger impact on the index than, for example, changes in thermal coal production (representing approximately 10-15% of total value).

Total production volume falls

The index at the end of the March 2015 quarter (latest available data) dropped to 128 points. This is a decrease of 5% from the December 2014 quarter and an overall increase of 2% over the year (June 14 - Mar 15). The index base is June 2006 = 100, so the total volume of production has grown 28% since that time.

Coal exports in the December quarter were down from 57 to 52 million tonnes. First quarter exports were adversely affected by weather events but volumes have since recovered to record levels in the second quarter. Preliminary port data suggests that Queensland coal exports in 2014-15 increased by 5 % to a new record of over 219 million tonnes.

Most commodities recorded lower volumes over the March quarter including aluminium (145 kt to 142 kt), bauxite (6,944 kt to 6,704 kt), lead (121 kt to 107 kt) and zinc (311 kt to 253 kt). Gold production (4 t) remained constant and only alumina (1,436 kt to 1,607 kt), copper (71 kt to 75 kt) and silver (340 t to 298 t) had increased production volumes.

Weighing up the net result of these changes in production volumes generate the 5% decrease in the QRC Production Index over the March quarter.

QRC VALUE OF PRODUCTION INDEX

QRC's value of production index reflects changes in Queensland's resource production at average global benchmark prices. The weighted index reflects the same mix of commodities as the QRC production index. Once again, LNG exports are not yet included in the index until we have more than one company exporting.

Total value drops

The combination of overcapacity and slowing consumption growth have led most mineral and energy commodity prices to decline in the past year. The index at the end of the March 2015 quarter (latest available data) fell to 127 points, down from 132 in the previous quarter. In aggregate, the resources sector recorded sales of \$AU7.96 billion in the March quarter, down 4% from \$AU8.3 billion in December 2014 quarter.

The March quarter decrease was due primarily to price decreases for aluminium, lead and silver along with further declines in average coal prices across the quarter for both thermal (\$US63) and metallurgical coal (\$US113). These decreases were offset by marginal increases for alumina, copper and silver. The Australian dollar has depreciated against the US dollar over the past twelve months but still remains at high levels compared with long-term averages. The combination of lower commodity prices and a lower relative interest rate are likely to result in further downward pressure on the exchange rate.

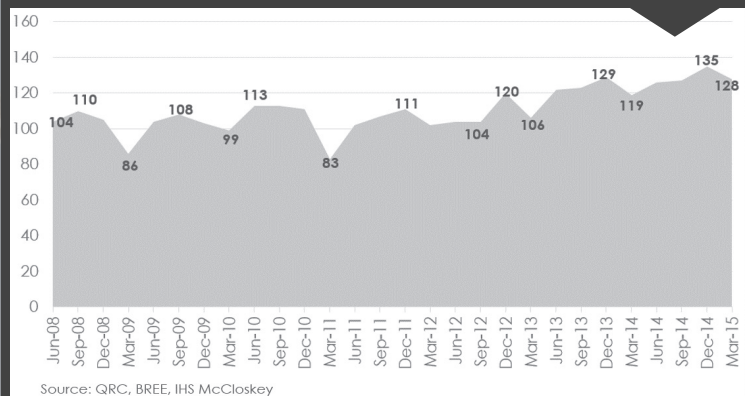
Prices increased for alumina (\$US316/t to \$US363/t), while aluminium (\$US1,992/t to \$US1,966/t), copper (\$US6,994/t to \$US6,621/t), gold (\$US1,289/oz to \$US1,284/oz), lead (\$US2,182/t to \$US2,050/t), silver (\$US1,975/troy oz to \$US1,650/troy oz) and zinc (\$US2,311/t to \$US2,235/t) recorded price falls over the quarter.

PRICE OUTLOOK

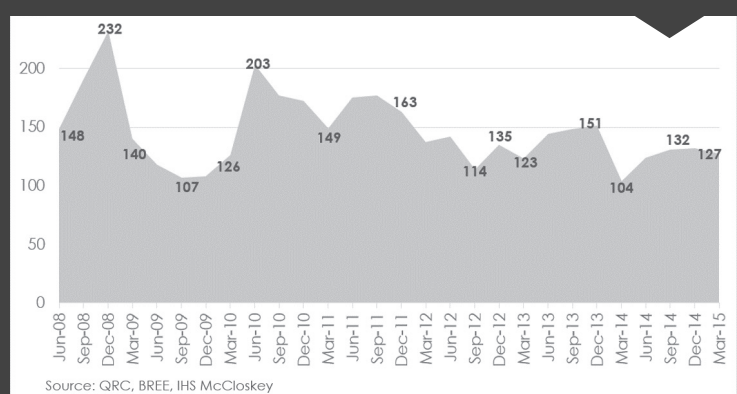
Queensland production of commodities is continuing to expand incrementally despite the environment of lower prices. The widespread fall in commodity prices through 2014 and early 2015 have led producers to shift focus from step-change production expansion to managing costs and productivity. As a result exploration expenditure, employment and capital spending are all down in Queensland, and more broadly in Australia. In the short term, market conditions are likely to be challenging for many producers. However, in the longer term the continued rise of highly populated emerging economies will continue to drive growth in consumption of both mineral and energy resources.

**Please note, until we have more than one company exporting, we are yet to integrate LNG prices and volumes into the index.*

QRC PRODUCTION INDEX (QUARTERLY)
(INDEX BASE JUNE 05/06=100)



QRC VALUE OF PRODUCTION INDEX (A\$) (QUARTERLY)
(INDEX BASE JUNE 05/06=100)



Metals

The June edition of the *Resources and Energy Quarterly* notes a small surplus has emerged in zinc markets at the start of 2015. However declining stocks, growing consumption and reduced availability of mined zinc are expected to support higher zinc prices in the short term. Gold export values are forecast to increase 4.8% to \$14.6 billion in 2015-16 relative to 2014-15 due to increased volumes and an expected lower exchange rate for the Australian dollar. In 2015 the average LME copper price is forecast to decline 14% to US\$5905 a tonne, underpinned by a market surplus and growing stocks.

Surplus aluminium production capacity in Asia, lower consumption growth and negative market sentiment stemming from concerns about China's economic growth have contributed to lower aluminium prices in early 2015. For the full year 2015, prices are forecast to average US\$1,819 a tonne, 2.5% lower than 2014.

The alumina spot price is forecast to increase by 3.6% in 2015 compared to 2014, to average US\$343 a tonne. After dropping in the March quarter 2015, alumina prices have shown some recovery, although lacklustre demand in China, where supply has increased and smelter costs have declined, is expected to contribute to moderated price growth for the remainder of the year. Alumina prices are forecast to increase slightly in 2016, averaging US\$348 a tonne for the year.

Metallurgical coal

After remaining relatively steady throughout 2014, metallurgical spot prices declined substantially in the first half of 2015 as surplus supply and weaker Chinese import demand weighed on prices. The market is expected to remain oversupplied until announced production cuts materialise and demand growth begins to recover. Australian benchmark contract prices for high-quality metallurgical coal delivered in the June quarter 2015 settled at US\$109.50 a tonne, down from US\$117 a tonne in the March quarter. Contract prices are expected to remain weak over the remainder of 2015 owing to continued surplus supply and weak steel prices. For 2015 as a whole, contract prices are forecast to average around US\$104 a tonne, 17% lower than 2014.

Thermal coal

Thermal coal prices continued on a downward trajectory in the first half of 2015 in response to surplus supply and lower import demand from China. Newcastle free on board prices began 2015 at around US\$62 a tonne and declined progressively to around US\$54 a tonne in mid-April. Prices have since recovered but remain below US\$60 a tonne.

The large volume of new coal-fired capacity under construction or approved, particularly in non-OECD countries, indicates that coal is likely to remain a primary energy source for electricity generation. The relative abundance, low-cost and geographic dispersion of coal resources and the reliability of coal-fired technology will continue to support its use.

Although the current operating environment has been more challenging for Australian coal producers, Australia's thermal coal exports remained resilient. Demand for Australian coal in key markets including Japan, South Korea and Chinese Taipei remained relatively steady during 2014-15 and the trend so far in 2015 confirms that India is set to become the biggest Asian market for our thermal coal, with Indian imports of thermal coal reportedly jumping 23% in the first quarter of 2015.

Eastern Australian gas prices

Eastern Australian gas prices have been mixed since the start of the year. Commissioning at Queensland Curtis LNG (QCLNG) resulted in sharp spikes at the Wallumbilla hub and Brisbane short term trading market (STTM). Prices have since moderated as wells feeding QCLNG have come online, but are expected to remain volatile over the remainder of the year and into 2016. CSG well ramp-up and management in support of new LNG plants will be a key determinant of short term Eastern Australian spot gas prices.

In order to generate cash flow, operators of new LNG projects will strive to maximise output regardless of whether buyers take contracted volumes. This is likely to promote spot market competition and underpin growing imports of uncontracted LNG into Europe and emerging regions (such as ASEAN and India) – from a combined total of 95 million tonnes in 2014 to 116 million tonnes in 2016. Total global LNG imports are expected to grow strongly, from 239 to 271 million tonnes between 2014 and 2016, but not enough to prevent a short term supply overshoot.

WHAT NOW FOR ECONOMIC INFRASTRUCTURE INVESTMENT?

Edited transcript of speech delivered by QRC Chief Executive Michael Roche to the Heavy Haul Rail 2015 Conference in Perth, June 2015.

When the LNP Government said in 2014 that it was prepared to enter into agreements with coal developers to enable major infrastructure in the Galilee Basin, there were predictable howls from activists and a declaration by the then Opposition that in government it would not put taxpayers' funds into such projects.

It was a curious response to the proposition that a state government might actually return to a role that had been 'bread and butter' business for over a century.

In the formative days of the modern resources sector, Queensland governments were active partners in fostering growth. They invested in infrastructure ahead of demand, confident that by creating commercial opportunity, sufficient economic activity would allow them to recoup their investment.

State governments built the coal rail network and the Great Northern Line connecting Mount Isa to the Port of Townsville. They also built most of the ports servicing resources sector exports.

However, since the turn of the century, both ALP and LNP governments in Queensland have embarked on programs to divest themselves of port and rail assets.



QRC STATE OF THE SECTOR

Most of the state's coal is now carried on Aurizon's monopoly coal rail network in central Queensland and more than half of its coal exports move through privatised port facilities. Even at the government-owned Port of Gladstone, the Wiggins Island Coal Export Terminal was developed by the coal industry following the refusal of a previous ALP government to borrow funds for the project.

After the shellacking the ALP took at the 2012 election for privatising businesses like QR National (now Aurizon), it campaigned fiercely and successfully at the 2015 election against the Newman Government's own privatisation plan (Strong Choices).

Now Queensland has an ALP government firmly committed to retaining state-owned electricity, port and remaining rail assets. The LNP has – for the time being – walked away from future privatisation programs.

So what is the future for economic infrastructure investment in Queensland?

With both major parties opposed to further privatisation, the big question is whether remaining government infrastructure businesses are going to be allowed to play an active development role.

The public has to start asking its leaders where the public assets of the future are to come from, if not the product of visionary investments by governments of the day.

That's what the QRC will be putting to the Queensland Government in its consultations on the State Infrastructure Plan and what we will also be asking of the federal government.

A consistent government position on infrastructure sends a strong signal to potential investors and potential customers.

The QRC believes government has a genuine industry development role in infrastructure. Government investments should be focused on addressing market failures, including an explicit transition mechanism after the market failure has been addressed.

State and federal government should play a greater role in the funding and initiation of scoping studies that help parties identify expansion opportunities, growth paths and infrastructure requirements.

Going a step further, government should also consider being financially involved in the early design and construction stages of a project before ceding control and ownership to commercial parties on appropriate cost recovery terms.

Examples are the Connors River Dam and new greenfield rail corridors such as in the Galilee Basin and extensions or connections between existing export corridors – such as the Surat Basin Rail project linking the Surat coal basin in southern Queensland with the Port of Gladstone.

QRC CEO SENTIMENT INDEX

The QRC CEO Sentiment Index is conducted quarterly across producer members. The participating companies cover most mining, minerals processing, contracting, exploration, electricity generation and oil and gas extraction activity in Queensland.

The chart below focuses on the change in sentiment towards key issues over the past 12 months. High input costs remains a top four issue for our CEOs and there was a lift in negative sentiment about costs in the June Quarter. We also asked CEOs whether they had plans to further reduce unit costs of production in the next 6-12 months. Four out of five CEOs said yes, with 21% of respondents targeting a reduction of more than 10% and 29% targeting a reduction of 5-10%. It should be noted that unit costs can be influenced by both increasing production and by reducing costs.

SEPTEMBER 2014 - JUNE 2015 CEO SENTIMENT RESULTS (TOP 6 WITH STRONGLY NEGATIVE SENTIMENT)

