

**'THE WORLD SETS OUR PRICES AND AUSTRALIA SETS OUR COSTS'**

- DEAN DALLA VALLE, BHP BILLITON COAL PRESIDENT

BY MICHAEL ROCHE - CHIEF EXECUTIVE



**In what continues to be a very difficult period for the Queensland resources sector and especially coal producers, some encouraging findings have emerged from our most recent survey of members.**

A major outcome is where resources companies sit on their respective global cost curves. In response to low prices, a persistently strong Australian dollar and structural cost problems, over the past 12

months resources companies have embarked on extensive cost management programs. Our feature article (page 3) highlights the results of these programs, noting that in March 2013, our member survey revealed 60 percent of operations in the top two cost quartiles. Encouragingly, the cost management programs, complemented by significant productivity gains, have been effective with Queensland producers moving down their respective cost curves and thereby improving their global competitiveness.

However, there is no hiding from the fact that coal prices are so low that the majority of Queensland coal operations are continuing to lose money (see our 'price outlook' on page 2). Apart from the obvious economic and social costs associated with mine closures, zero or low returns have significant longer term implications for attracting sustaining and growth capital for brownfield and greenfield expansions.

BHP Billiton's coal president, Dean Dalla Valle told a CEDA event in Brisbane that 'the world sets our prices and Australia sets our costs.' Given limited prospects for a substantial increase in commodity prices or depreciation in the Australian dollar any time soon, we will need to do more on the costs front, and share the burden in doing so.

The QRC believes there is room to move on labour, taxation, electricity, regulation and rail costs. Our labour costs far exceed those of our global competitors. The sector is seeking cooperative, productive, and financially viable workplaces and greater collaboration and genuine restraint among the parties in setting wages.

Based on company tax and royalty collections, resources is

already among the highest taxed industries in Australia, which is a relatively high tax jurisdiction compared to global competitors. We therefore encourage the government to index the coal royalties thresholds and stay their hand on new and increased taxes and charges in its June budget; and scrap proposals for new minesite statutory positions, which will add tens of millions in new costs. Furthermore, the MRRT should be repealed immediately to improve industry confidence and signal Australia's determination to remain a premier investment destination investment.

With a carbon price of \$24.15/t CO<sub>2</sub>-e, Australian emitters are paying four times as much as the next most expensive regime – and no other jurisdiction taxes fugitive emissions from coal mining. The Senate needs to get out of the way of the repeal of both taxes.

In relation to energy, rail and port costs, infrastructure providers need to come to the party with charging regimes attuned to the reality of low commodity prices. For example, Queensland Rail's proposal to substantially increase the reference tariff for (thermal) coal carrying train services on the Western System is out of touch. The recent decision to shut the Wilkie Creek mine near Dalby highlights the economic reality.

From \$8.50/'000gk in 2005 and the \$18.18/'000gk currently in place under a Temporary Undertaking, QR wants to increase the tariff by 22 percent to \$22.22/'000gk backdated to 1 July 2013.

More broadly on regulation, significant benefits will accrue once the so called 'one-stop-shop' streamlining state and federal government environmental approvals is implemented. The Queensland Competition Authority's draft CSG regulation review (November 2013) points to the need for a fit-for-purpose legislative framework for a world-class CSG to LNG industry. The reality is that Queensland's rich endowment of minerals and energy resources is no longer a guarantee of future success and prosperity.

All stakeholders have a role to play in improving the competitiveness of the sector in increasingly difficult operating environments.

**IN THIS EDITION:**

- Key indicators: QRC Production and Value of Production Indices, including price outlooks
- Feature article – Cost curve comparison
- QRC CEO Sentiment Index



## KEY INDICATORS

### QRC PRODUCTION INDEX

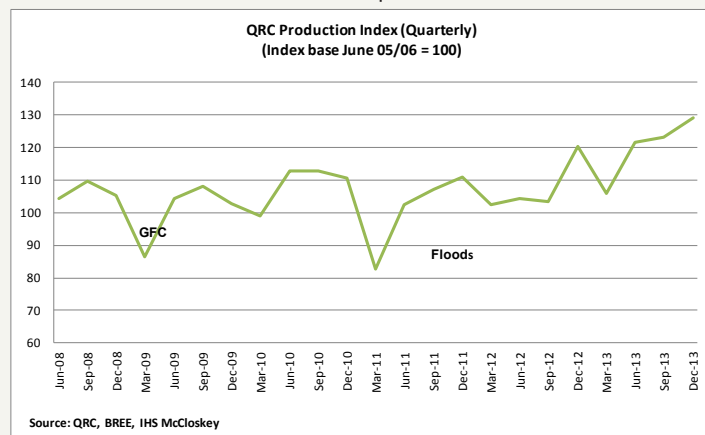
The QRC production index is a composite weighted index that tracks percentage increases and decreases in the total production of Queensland bauxite, alumina, aluminium, coal, copper, gold, lead, silver, and zinc quarter to quarter.

Weightings are on a value of production basis; hence changes in coal production (representing 70 percent of the Queensland resource sector's total value of production) have a proportionately larger impact on the index than changes in silver production for example (representing just 5 percent of total value of production). Note – because Queensland is not yet producing significant quantities of additional coal-seam gas this output has not been included.

The index at the end of the December 2013 quarter (latest available data) reached 129 points. This is an increase of 6 percentage point from the September 2013 quarter (June 2006=100).

Record amounts of coal are passing through Queensland ports and consequently pushing the production index higher. The total volume of Queensland coal exported in the December quarter was up 6 percent from 50.8 million tonnes to 54.3 million tonnes. Total Queensland coal exports for the 2013 calendar year were at a record 196 million tonnes. Indicative data for the first three months of 2014 shows volumes closer to the 50 million tonne mark given some regular maintenance, wet weather impacts, and the anticipated post CY downturn.

A number of commodities including zinc (245kt to 268kt), alumina (1476kt to 1599kt) and silver (337 t to 358 t) also recorded higher production volumes over the December quarter. Aluminium (142kt to 139kt), bauxite (6971kt to 6787kt), copper (77kt to 74kt), gold (5t to 4t) and lead (125kt to 124kt) recorded decreases in production.



### QRC VALUE OF PRODUCTION INDEX

Comprising the same basket of goods as the QRC production index, the QRC value of production index is also a weighted index.

It combines domestic production and average global

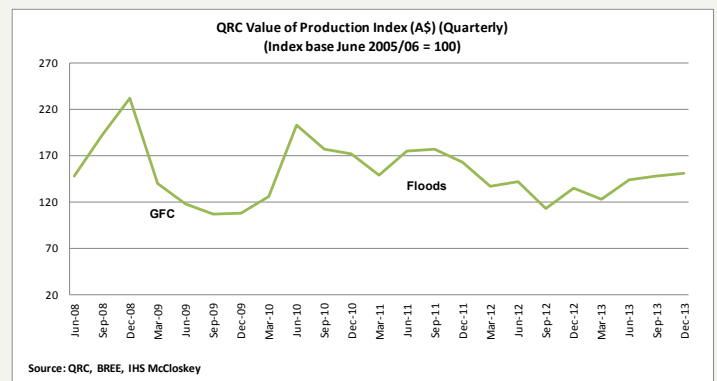
benchmark prices to track percentage increases and decreases in the Queensland resource sector's total value of production.

The index at the end of the December 2013 quarter (latest available data) reached 151 index points, up from 148 in the previous quarter. In aggregate, the resources sector recorded sales of A\$9.5 billion in the December quarter, up from A\$9.4 billion in the September 2013 quarter.

Again the increase was primarily down to higher coal export volumes despite, perversely, falling metallurgical coal prices and stabilising thermal coal prices.

Spot thermal coal prices made small gains although continued to stay very low between US \$79-85/t (Newcastle FOB marker, high CV and 6000kc NAR basis) whilst Australian prime hard coking coal traded in the spot market for around US\$136/t by the end of December 2013.

Aluminium (US\$1781/t to US\$1769/t), alumina (US\$321/t to US\$300/t), gold (US\$1326/oz to US\$1271/oz), silver (US\$2135/troy oz to US\$2082/troy oz) recorded decreases whilst lead (US\$2102/t to US\$2111/t), copper (US\$7079/t to US\$7153/t) and zinc (US\$1859/t to US\$1909/t) recorded increases over the quarter.



### PRICE OUTLOOK

The global market for thermal and coking coal remains oversupplied with producers focused on rationalisation and cost cutting to increase international competitiveness.

While there are signs that a number of marginal producers globally are unlikely to continue producing, significantly more coal will enter the market as new projects are commissioned.

Spot prices for seaborne premium Australian hard coking coal continued to fall into 2014 reaching a historical low of US\$113/t. The downward trajectory in spot coking coal prices, in place since October last year, appears to be slowing, although overall demand remains relatively weak and supply is still strong.

In relation to thermal coal, it is speculated that Australian producers have settled April-start Japanese Power Utility (JPU) contracts at US\$81.80/t FOB. This amounts to almost 14 percent drop on the ruling 2013 April-start price of \$95.00/t 12 months ago.

# STATE OF THE SECTOR

In relation to metals, prices are expected to continue to weaken given the slowing of the Chinese economy and lower than anticipated global economic growth. However, there are signs that supply deficits may emerge in key markets given the lack of new global supply coming on over the next few years.

Prices for domestic gas are also expected to continue to increase in line with tight supply, increasing export prices and increasing discovery and conversion costs.

## COST CUTTING & COMPETITIVENESS

**In an attempt to gauge the results of cost cutting during this cycle the QRC re-surveyed members with the same question from our March 2013 State of the Sector report .**

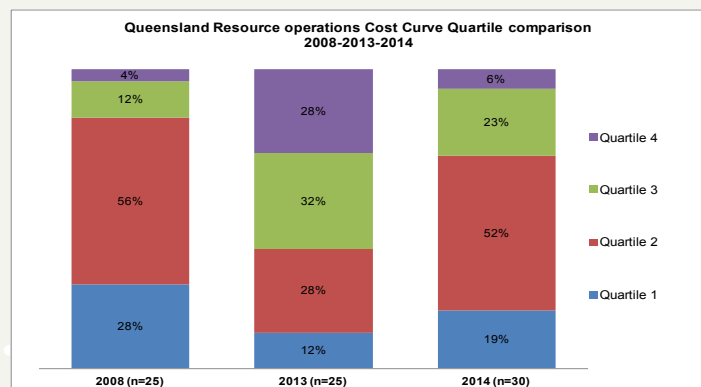
A year ago the QRC asked the CEOs of its full member companies (across all commodities) to divulge cash operating cost curve information. This was to establish where the same operations sat in 2008 and 2013 on their global cost curves. A total of 19 companies supplied data from 25 operations. In this month's survey 21 companies responded with data covering 30 operations. These operations are a mix of mining, minerals processing, oil and gas production and 'other' activities.

### Methodology

Global cost curve analysis is a powerful tool in helping to determine whether a nation's commercial and public policy settings are conducive to competitive resources extraction and investment attraction, and if the sector is likely to stay globally competitive through price cycles. In theory, operations in the upper third and fourth quartiles are likely to be replaced by lower cost producers over time.

### The results

In 2008, more than 80 percent of operations sat in the first and second quartiles meaning only 20 percent were exposed to higher risks in the upper third and fourth quartiles. In 2013, following a sustained period of high prices and considerable competition for business inputs, the balance shifted and only 40 percent of operations remained in the first and second quartiles. This meant the majority of producers were under serious competitive threat if they could not reduce cost profiles.

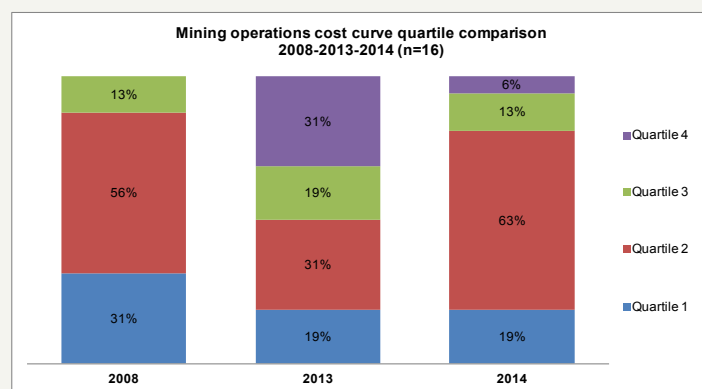


According to the latest survey results, in 2014 30 percent of those high-cost, at-risk operations have successfully reduced costs to fall back into quartiles one or two. Encouragingly, 70 percent of operations report they are in the bottom two quartiles, noting 84 percent were there in 2008.

Interestingly, we can also distinguish cost curve quartile comparisons by category: mining, minerals processing, oil and gas and contractors. The drastic cost profile change over the past 12 months is particularly evident in the mining operations chart. In 2013 half of all operations were operating in the highest two quartiles, but after rigorous cost cutting and significant productivity gains (through improved equipment utilisation and higher volumes), more than 80 percent of operations are now in quartiles one or two.

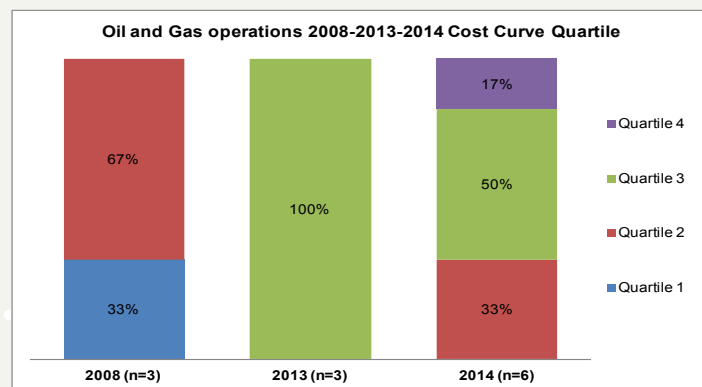
However, given very low coal prices, operations in quartiles three and four (and possibly quartile two) would not be recovering their cash costs and thereby operating at a loss.

Given that coal producers commit to take-or-pay contracts



for rail, port, water and power (meaning they pay for the contracted capacity regardless of usage), losses would typically need to be greater than the take-or-pay cost commitments before a mine opted to shut the operation down and incur the full take-or-pay liability and all other associated costs (eg redundancy costs).

The QRC estimates that a significant percentage of Queensland coal operations are operating at a loss, but anticipated losses do not yet exceed full take-or-pay cost liabilities and other expected shut down costs. This situation may change if the Australian dollar continues to appreciate



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and if coal prices continue to fall.

The implications of this are significant in the short and longer term. Mining shutdowns will lead to large direct job losses, even greater flow-on job losses in service providers and a significant decrease in government revenues. Longer term, companies making sustained losses or anaemic returns will not earn the needed capital to replenish depleted reserves and/or invest in future projects.

A different perspective comes from the analysis of oil and gas cost profiles (from a smaller sample). In 2008 these operations sat in quartiles one and two.

In 2013 escalating costs moved them into quartile three. Today, two thirds of operations remain exposed to serious competitive cost pressures as they sit in quartiles two and three, despite increasing gas prices.

## QRC CEO SENTIMENT INDEX

The QRC CEO Sentiment Index is a survey of the QRC's full member company chief executives. These companies cover the majority of mining, minerals processing, contracting, exploration, electricity generation and oil and gas extraction activity in Queensland. The top six areas of concern over the next 12 months for resource sector CEO's include:

1 Global macroeconomy = continued global economic uncertainty and weak economic conditions, especially slowing growth in China and India. The continued oversupply in some markets is depressing commodity prices.

2 Raising capital = raising capital on the debt and equity markets remains difficult given low commodity prices, regulatory burden and perceived sovereign risk. Securing internal funding within the larger organisations is also difficult as shareholders request larger dividends.

3 Uncertain and/or poor regulation = Despite continued political rhetoric about red and green tape reduction, the regulatory approvals process, both state and federal remains complex and uncertain.

4 High input costs = the increasing AUD against the USD result; high effective tax and royalty burden and the general increase in the array of increased government charges; high labour costs; high energy costs increasing mainly on account of network and green costs and domestic gas scarcity; and productivity challenges (mainly from resources depletion).

5 Social licence to operate = Mobilisation of the environmental activist groups, including unfounded claims re the potential impacts of resources extraction (eg ship movements and anchoring and dredge spoil on the health of the Great Barrier Reef).

6 Insufficient government resources = the fiscal repair task of state and federal governments is depleting the policy and regulatory capacities of key government agencies.

