

QRC STATE OF THE SECTOR

MARCH QUARTER 2015

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THE NEW QUEENSLAND GOVERNMENT - MOSTLY STEADY AS SHE GOES

**By Michael Roche, Chief Executive
Queensland Resources Council**

A recurring question in discussions with QRC members, industry leaders and the media is: 'How do you find the new state government to work with?'

In response, I point to the fact that since the creation of the Queensland Mining Council in 1991, the peak representative body for the state's minerals and energy resources has worked with ALP governments for 19 of the intervening 24 years.

We recall that the QRC worked alongside Premiers Beattie and Bligh to deliver the policy settings that underpinned the biggest private sector investment phase in the state's history, including creation of the world's first coal-seam gas export industry.

We are encouraged by the fact that the Palaszczuk Government has given the green light to many of the initiatives of the LNP administration that were in train when the election was called. We may see some re-branding but the essence of many important initiatives remains intact.

This business as usual approach is also being encouraged by the appointment of key advisers who worked closely with QRC in the past and are advising their new Ministers accordingly.

One of the first encouraging signals from the new government is that it has resisted the temptation to renovate the machinery of government inherited from its predecessor.

Over the next few months, a formal merit-based process will confirm the appointment of Directors-General, and while some new faces are expected, it is reported that many incumbents are quietly confident they have demonstrated strong claims for their positions.

In our quarterly survey of member company CEOs for this edition, we sought views on whether the new government had affected investment confidence or business outlook.

Predictably, the overwhelming consensus is 'too early to tell'. The resources sector is judged on outcomes, and appears to be applying the same test to the new government.

Premier Palaszczuk has defined her government as consultative and jobs focussed. We trust that these defining characteristics will be in evidence in how the government deals with pressures to reinstate a ban on uranium mining and bring sand mining operations on North Stradbroke Island to an abrupt and premature halt, while also resisting a Sydney shock jock's campaign to kill off hundreds of local jobs at the New Acland coal mine on the Darling Downs. This is the same shock jock who has campaigned to destroy 1800 coal mining jobs at two Hunter Valley coal mines.

The state government's early achievements (lead by Environment Minister Dr Steven Miles) in finalising the Reef 2050 Plan with the federal government and developing a dredging solution for the Abbott Point coal terminal are commendable, as was the introduction of legislation which should ensure that copper mining and smelting in Mount Isa can continue beyond 2016.

The Palaszczuk Government also continues to show its political support for the development of the Galilee Basin and associated supply chain infrastructure. We are seeing the Deputy Premier playing a strong and constructive role behind the scenes.

While our sector is going through a remorseless process of cost cutting to reflect market conditions (see our feature article), it is still a mainstay of regional Queensland. No-one understands this better than Treasurer Curtis Pitt who represents a Cairns region electorate where youth and indigenous unemployment are major challenges. QRC hopes to renew our indigenous jobs MOU with Mr Pitt shortly.

Also making good impressions is Minister for State Development, Natural Resources and Mines, Dr Anthony Lynham. He's been getting around the state's resources map and has impressed hosts with his willingness to understand an issue rather than arriving with an opinion. His portfolio responsibilities are broad and pivotal to the success of the government's jobs ambitions.

No discussion around the future of the resources sector in Queensland is complete without reference to the Queensland inquiry into 'Fly in, fly out and other long distance commuting work practices in regional Queensland.'

As most members are aware, the inquiry is being chaired by former CFMEU-funded 'community advocate' and once-retired but returning MP for Mirani, Jim Pearce. His Infrastructure, Planning and Natural Resources Committee is scheduled to report to Parliament at the end of September.

To ensure this inquiry has the best evidence to hand, we will be asking QRC members to help us update a 2012 survey of workers, which ensured that 2,300 resident and non-resident workers were given a say in a debate too often conducted about them rather than with them.

QRC will be making its comprehensive submission to the committee next month.



KEY INDICATORS

QRC PRODUCTION INDEX

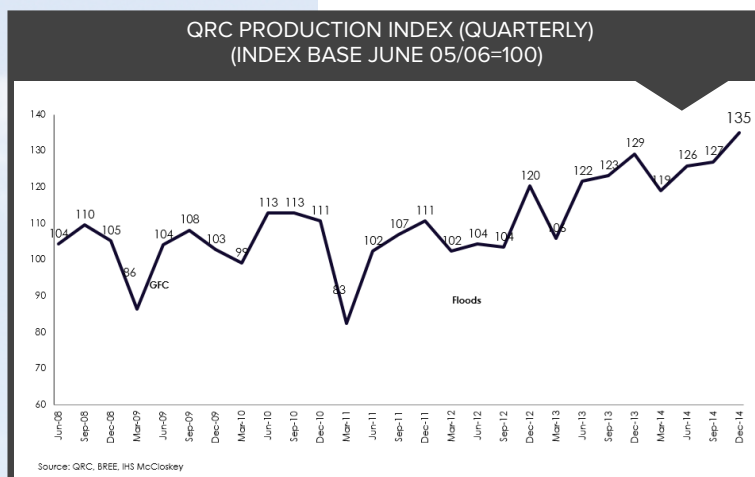
QRC's quarterly production index tracks changes in the total production of Queensland's traditional resources – bauxite, alumina, aluminium, coal, copper, gold, lead, silver, and zinc. The index is weighted by the value of production. This means changes in the volume of coal produced (70% of the value of Queensland resources production) has a proportionately larger impact on the index than, for example, changes in silver production (representing 5% of total value). While the December quarter 2014 marked the world's first export of LNG sourced from Queensland coal-seam gas, we are yet to integrate LNG prices and volumes into the index.

Total production volume grows

The index at the end of the December 2014 quarter (latest available data) reached 135 points. This is an increase of 8% over the September 2014 quarter and an overall increase of 16% over the year (Mar 14 - Dec 14). The index base is June 2006 = 100, so the total volume of production has grown 35% since that time.

Coal exports in the December quarter were up 4% from 55 to 57 million tonnes. Annual coal exports in 2014 reached a record 216 million tonnes, equating to a 10% increase on the 2013 year.

Most commodities recorded higher volumes over the December quarter including aluminium (143 kt to 145 kt), bauxite (6,844 kt to 6,944 kt), copper (63 kt to 75 kt), lead (108 kt to 121 kt) and zinc (228 kt to 311 kt). Gold production (4 t) remained constant and only alumina (1,582 kt to 1,436 kt) and silver (340 t to 298 t) had reduced production volumes.



Weighing up the net result of these changes in production volumes generate the 8% increase in the QRC Production Index.

QRC VALUE OF PRODUCTION INDEX

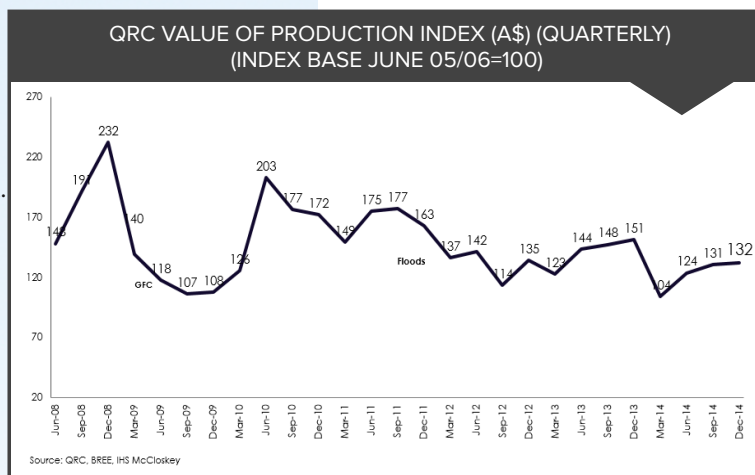
QRC's value of production index reflects changes in Queensland's resource production and average global benchmark prices. The weighted index reflects the same mix of commodities as the QRC production index. Once again, LNG exports are not yet included in the index.

Total value grows

The index at the end of the December 2014 quarter (latest available data) reached 132 points up from 131 in the previous quarter. In aggregate, the resources sector recorded sales of \$AU8.3 billion in the December quarter, up from \$AU8.2 billion in September 2014 quarter.

This slight increase was due primarily to price increases for alumina, aluminium, copper, lead and silver. These increases were offset by further declines in average coal prices across the quarter for both thermal (\$US68 from \$US73) and metallurgical coal (\$US114 from \$US115). The depreciation of the Australian dollar against the US dollar also contributed to the increased index.

Prices increased for alumina (\$US316/t to \$US363/t), while aluminium (\$US1,992/t to \$US\$1,966/t), copper (\$US6,994/t to \$US6,621/t), gold (\$US1,289/oz to \$US1,284/oz), lead (\$US2,182/t to \$US\$2,050/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. Average quarterly prices for both the rmal and metallurgical coal also dropped by \$US5/tonne and \$US1/tonne respectively.



PRICE OUTLOOK

The supply surplus in most commodity markets is expected to persist over the short term and contribute to sustained softness in commodity prices. As global investment slows and unprofitable production is closed, supply growth is projected to slow. Despite the forecast decline in export earnings in 2014-15, the outlook for Australian minerals and energy exports remains positive.

Metals

In 2015, the average aluminium price is forecast to be \$US1,913, around 2% higher than 2014. Over the next five years, real production costs are likely to fall as new, larger and more energy efficient smelters displace outdated facilities. Alumina prices are forecast to increase 6% cent in 2015, to an average price of \$US349/t, as consumption increases are maintained to provide alumina as an input into new and expanded smelters.

The anticipated copper surplus failed to materialise in 2014, with new production capacity taking longer than expected to reach promised rates. In 2015, copper prices are forecast to fall 13% to \$US5,968/t as the market moves into a long expected surplus and stocks increase. Over the short to medium term, zinc consumption growth is projected to outpace production growth, supporting a steady increase in prices.

Metallurgical coal

Metallurgical coal prices were relatively stable in 2014, unlike other bulk commodities, indicating the market is closer to balance. A strengthening US dollar and lower fuel prices have reduced costs in major producing regions. This has encouraged some price competition and supported a slight drop in prices in early 2015. The market balance is expected to tighten from 2016 as increased steel production in China and India and the closure of high-cost production capacity reduces supply availability. Metallurgical coal prices are expected to remain subdued until demand growth recovers and further mine closures materialise. However, reduced financial pressures may slow the closure of high cost operations. This, in combination with increased price competition, is expected to keep metallurgical coal prices low during 2015.

Thermal coal

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. The delayed closure of unprofitable capacity is expected to extend the supply overhang into 2016–2017 and continue to place downward pressure on prices and force uncompetitive operations to close.

Eastern Australian gas prices

Gas prices on the eastern seaboard were mixed over the past quarter. In Queensland, the Brisbane Short Term Trading Market (STTM) fell consistently through 2014 up until November, when it averaged \$0.3 a gigajoule for the month. The price rebounded in December and averaged \$4.7 GJ in January as the Queensland Curtis LNG project began operation – reducing the amount of uncontracted gas available to the market.

Prices are not expected to ease again over the outlook period as the ramp up of QCLNG combined with the impending start-up of Asia-Pacific LNG (APLNG) and Gladstone LNG (GLNG) maintain pressure on gas supply later this year. Prices in the STTMs are expected to be higher and more volatile over the outlook period as uncontracted gas is in greater demand. Lower oil prices will result in much lower netback prices in Queensland, but this will do little to ease demand from LNG projects which have contracted volumes to supply. Buyers renewing and re-negotiating domestic contracts, which cover the majority of domestically consumed gas are also expected to face higher real prices than they have in the past as a large portion of gas reserves are allocated to LNG plants.

INDUSTRY COST CUTTING PAIN YIELDS RESULTS

One of the iron laws of an export industry is that while the world sets our prices, we set our costs.

Over more than a year, as the tide of global commodity prices swept out, many in the resources sector struggled initially to wind back costs to keep pace with prices.

The result was a wave of downsizing, restructuring and contract renegotiation that has dramatically changed the face of the industry.

In briefing new ministerial teams, one fact never fails to grab attention – at current spot prices, 43 percent of Queensland's thermal and 5 percent of coking coal production is loss-making. Fortunately, not all coal is traded on spot markets, and contract prices are less volatile.

Nonetheless, it is a harsh lesson for many in government that at a time when minerals and energy producers are losing money, key service providers such as rail, port, water and power are still earning good returns on the back of 'take or pay' contracts.

This means that mines pay for contracted capacity regardless of whether it is used. In this environment, cash 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.

Similarly, while low global oil prices have provided welcome cost relief for many miners and explorers – the media has gleefully reported the impact that these prices have had on the LNG export industry whose sale price is indexed to oil.

The state government has plenty of skin in this game. With their royalties set against sale price, every fall in commodity prices drags down royalty revenues. Such reality confronts Treasury as they work towards the 14 July state budget.

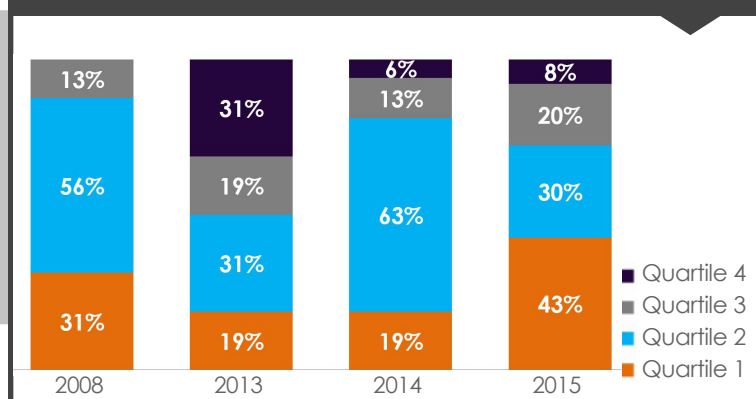
In April, QRC surveyed QRC full members across all sectors. We asked CEOs to benchmark the cash costs of their operations against their peers and competitors. We asked where their operations sat on the global cost curve. Using 2008 as the benchmark year, such analysis was undertaken previously in 2013 and 2014.

It is clear that the pain of industry cost cutting is delivering results. The charts over the page show that over the past year, Queensland mining operations have won strong improvement from 19% in cost quartile 1 (i.e. the lowest 25%) to the current 43%. Unfortunately, operations in the third and fourth quartile have increased from 19% to 28%. These are operations at risk.

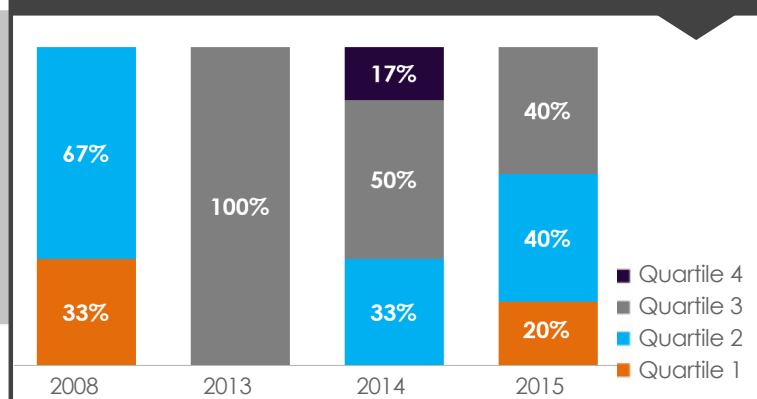


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MINING OPERATIONS COST CURVE QUARTILE COMPARISON
2008, 2013-2015



OIL AND GAS OPERATIONS 2008, 2013-2015
COST CURVE QUARTILE



For the oil and gas industry, the story is much more positive. Compared with a year ago, Queensland now has 20% of operations in the first quartile (bottom 25% of global costs) and 60% in the first two quartiles. While the industry is yet to return to the situation in 2008 when all Queensland operations were in the bottom two quartiles, as the LNG projects move out of construction and into operations, there are signs that these operations will move down the global cost curve.

Not tested in this survey, but an important part of the story has been the softening of the Australian dollar. With most export prices negotiated in US dollars, a lowering of the Australian dollar automatically helps to boost revenues in local currency terms.

QRC thanks member CEOs for their candor and willingness to share data. The collective picture this information provides is very important and QRC will work hard to ensure that decision makers understand the pain the industry is enduring as cost savings are relentlessly pursued.

QRC CEO SENTIMENT INDEX

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

The following chart focuses on the change in sentiment towards key issues over the last twelve months and demonstrates continuing high levels of concern with the global operating environment, social licence pressures as well as the uncertain and/or poor regulations.

2014 CEO SENTIMENT RESULTS (TOP 6 WITH STRONGLY NEGATIVE SENTIMENT)

To what degree will these macroeconomic factors adversely impact upon the objectives of your organisation over the next 12 months?

