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McDOUALL STUART

RESEARCH

COAL SECTOR

DOWN, BUT NOT OUT

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Key Points

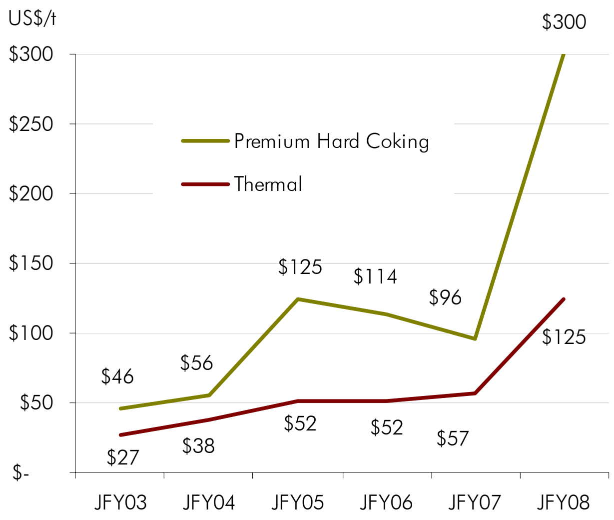
- Among the wider chaos, crunch time for 2009/10 international coal pricing benchmarks
- Production cuts appear to be supporting price outcomes
- Medium- to long-term supply outlook still tight.

2009/10 Coal pricing benchmarks taking shape

Negotiations for coal pricing benchmarks to apply for the year commencing 1 April are reported to be well advanced. Unconfirmed reports over the last few days have suggested that negotiations between Xstrata and Japan's Chubu Electric have concluded with a JFY09 thermal coal price benchmark of US$70-$72/tonne.

If indeed the case (no formal announcement has yet been made), the outcome is broadly consistent with market consensus, which had been seeking settlement in the US$70-$80/t band.

Figure 1: JFY03-JFY08 coal benchmark settlements



Source: McCloskey, McDouall Stuart Research

The outcome represents an average 43% reduction on the JFY08 benchmark, which settled at a record US$125/t. Looking past the JFY08 spike, US$70/t sits 56% higher than the five-year JFY03-JFY07 average of US$45/t.

The unconfirmed JFY09 result allays recent concern that softness in spot market thermal prices over the past few weeks would be relayed into contract prices. Spot indices for thermal coal out of Newcastle have continued to fall sharply, from US$80/t in mid-February to less than US$62/t this week.

Australian production cuts & forex lending support

The relatively favourable thermal benchmark settlement appears to have justified moves by Australian producers since late 2008 to cut production. Reports over the past couple of months have pointed to major producers, including Xstrata, Rio, Peabody, Anglo American and Macarthur, all cutting production.

Medium-term outlook still demand-heavy

While the short-term picture for thermal coal is clearly weak, headed by expected easing demand from Japanese and Chinese generators, the medium- to longer-term picture continues to point to strong demand growth.

Australian forecasting agency ABARE estimates that 579,000MW of new Asian coal-fired generating capacity is planned over the next 1-2 decades. China accounts for almost half of this growth, with 280,000MW planned before 2020. If all is developed, the equivalent to a new Huntly power station will be commissioned in China every two weeks for each of the next 11 years.

ABARE points out that even if only 20% of planned new capacity is built, this would still require an additional 340mt of annual fuel coal to meet, nearly half the level of current annual thermal coal trade globally.

Metcoal benchmarks still not settled

Unlike past years when coking coal settlements have tended to be the first announced to market, JFY09 metcoal negotiations have yet to be concluded.

Industry reports suggest that the delay reflects the stronger polarisation of buyer and seller views towards price, compared to thermal coal. This is likely a reflection of the different dynamics at play in the seaborne metcoal market, particularly on the demand side. Metcoal is a core process input to steel manufacture. Sharply easing demand from western nations for manufactured goods has flowed quickly up the supply chain to deliver sharp declines in steel production. The World Steel Association reported global steel production in January to be down 24% on the same month last year.

It takes around 1.7 tonnes of iron ore and 1.5 tonnes of coking coal to make a tonne of steel. A lack of indigenous iron ore in key consumption markets, particularly China, is likely to see tightness in the global ore market continue. However, the situation with metcoal is not as clear. With China largely self sufficient in coking coal, global trade volumes are likely to be led by trends in other key markets, notably Japan, the EU and India. While combined Indian and EU demand is expected to hold relatively steady in 2009, Japanese and Korean demand is not. Significant declines in steel production in those countries is forecast, which is likely to result in proportionate declines in metcoal demand.

Australian supply response

Australia accounts for around 60% of seaborne coking coal trade, much higher than for thermal coal where its share of global trade is only 16-18%. To a very large extent, therefore, Australian supply tends to act as the fulcrum of the seaborne metcoal market.

As with thermal coal, Australian metcoal producers have progressively cut production in response to demand conditions. In January, BHP Mitsubishi Alliance, the world's largest metcoal producer, announced its intention to cut production by 10-15% for the first six months of 2009, implying a cut of up to 4mt. Consistent with this, ABARE forecasts Australian seaborne exports of metcoal to drop from 135mt in 2008 to 125mt in 2009. Total global seaborne metcoal trade is forecast to fall by 25mt (10.7%) in 2009, from 233mt to 208mt.

Proxies pointing to US$120-$130/t HCC settlement

The settling of thermal benchmarks at approximately the level market consensus was seeking is a positive outcome for producers. Recent weakness on spot markets and the collective gloom of macro indicators coming out of major consuming nations had been raising concern levels in recent weeks.

Of further support may be very recent market speculation that POSCO, the world's second largest steel producer, may have settled JFY09 PCI supply contracts with some Australian suppliers at US$90/t. Although a fall of more than 60% from JFY08's US$245/t, if accurate, the result would be broadly in line with current market consensus for JFY09 PCI.

The accumulation of price signals is giving increasing support to the view that the JFY09 HCC benchmark is likely to fall within current market consensus of US$120-$130/t. While close to 60% lower than last year's US$300/t, a US$125/t result would present a 44% premium to the five-year pre-JFY08 average of US$87/t.

Longer-term, improving economic conditions and underlying tightness in the global supply/demand balance for metcoal is expected to support a long-term price curve at or above US$100/t.

A final point worth noting is the very substantial cushioning provided to producers by the appreciating US$. With the US$ having risen more than 30% against both the A$ and NZ$ in the past 12 months, on a like-for-like basis, currency will offset up to half of the expected declines in US$ JFY09 benchmark pricing.