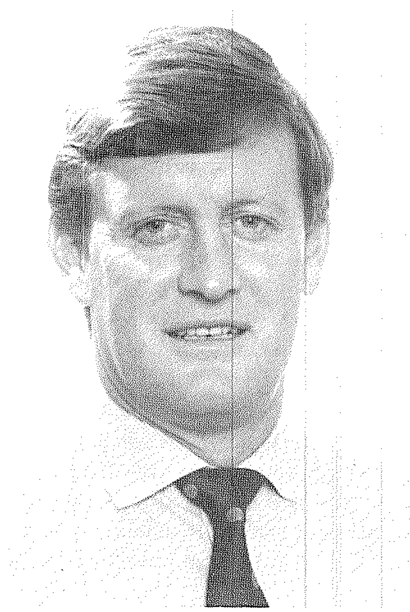
COAL: WINNERS AND LOSERS

PAINFUL ADJUSTMENTS MAY LIE AHEAD



by LEIGH CLIFFORD

Australia is a coal-rich country – but the industry is vulnerable because of restrictive government charges and work practices that need further review.

We talk about "the Australian coal industry" when that is not really the case. It is a series of industries. We have open-cut and underground, export and domestic suppliers, steaming and coking coal. The relationship between steaming and coking coal is less intimate than most people presume. Clearly the customers are different and the impact of exchange rates is different. Many of the problems of "the industry" relate to attitudes within the "protected" domestic coal industry. Because of my involvement in coking coal, my comments will relate mainly to coking coal.

In discussing the winners and losers, I am going to focus on New South Wales. NSW has really messed it up. Our rail charges are too high, our ports are not as competitive as those of our competitors (they are more costly, generally have less storage capacity and can handle only relatively small vessels). By and large, our resources aren't bad, but the way we exploit them puts us at a significant disadvantage.

The previous NSW Government created an environment for development significantly less attractive than that which existed in Queensland. Further, neighbours in the Sunshine State are closer to our key markets in Asia.

Can it change? Can NSW get its act together? I think ultimately it can, and one of the factors we have to remember is that Queensland's open-cut mines are getting deeper. There is room for some expansion, but much of the future development is going to be underground. Additionally, some of the infrastructure, be it towns, railways or ports, is starting to approach the limit of its capabilities. Big amounts of capital will be necessary to expand the capacity of Queenland's infrastructure – not just in terms of dollars per annual tonne of capacity, but big amounts in total.

Open cuts are getting deeper and I believe there is less scope for improving their cost position than for underground mines. The reason is that labour is a more significant percentage of total cost in underground mines compared with open cuts. Therefore, the scope for improvements in productivity, with the resultant decrease in costs, is greater than in open cuts. However, the only way this is going to occur is if longwalls are used to their maximum capabilities – notice that I said longwalls, not miners. Given that labour is a greater component of costs in underground mines, using longwalls more effectively means greater scope for cost improvement.

It is interesting to examine the sort of productivity levels enjoyed by new underground longwall installations in the US, some being two and three times what we achieve in NSW. These figures indicate what is possible. Clearly some of our longwalls do very well, but the majority are well behind our competitors

Leigh Clifford is Managing Director, Kembla Coal and Coke Pty Ltd. This is a revised version of an address to a 1988 Securities Institute seminar on the coal industry.

– who themselves are not standing still.

When we look at NSW coal, we can divide it into three major areas – the Hunter, the West and the South. Each area faces different issues.

In the Hunter, and the Upper Hunter especially, freight is a significant issue. Work practices are probably the worst in the whole of NSW which, in general, has a very much worse record than Queensland. In addition, the NSW Government's insistence on balancing underground and open-cut operations put the State further behind Queensland.

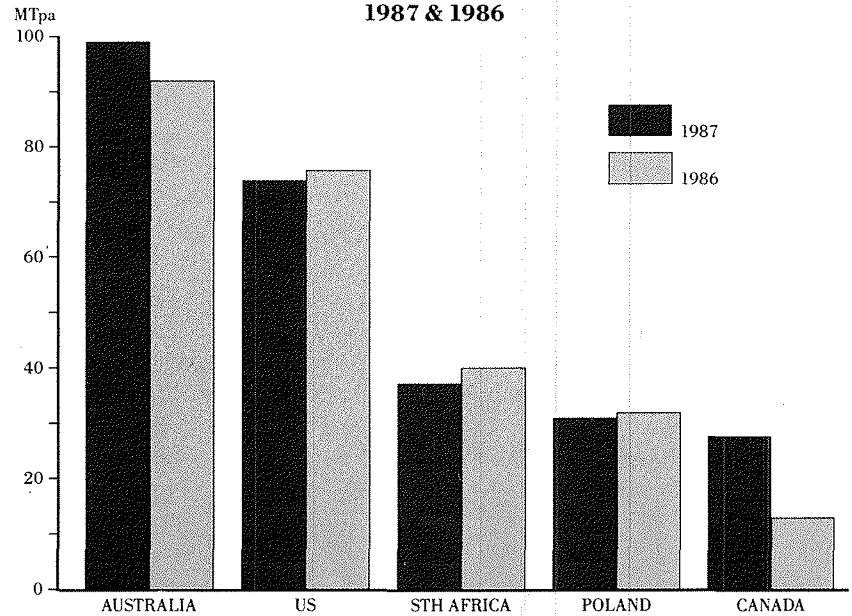
In the West, we have a lower-value product. Freight is a dominating influence and, again, there are significant work practice issues.

In the South, we have predominantly hard coking coal, therefore higher revenues. Generally, our physical mining conditions are not as good as those in the other areas. Transport problems, rather than resulting from distance, relate to the terrain of the Illawarra escarpment. Work practice issues are probably not quite at the low level of the other areas but significant opportunities for change do exist.

Who will be the winners? In steam coal, only the low-cost producers with flexibility and quality resources. This is because Australia has no monopoly position and steam coal ultimately is competing against other forms of energy as well as other producers. Australia has some very low-cost producers. However, the Colombians, Indonesians, Chinese and Venezuelans will be trying to secure market share. We have no monopoly on new production.

In coking coal, the winners will be those who are successful at making significant changes. I might add that KCC intends to be one of these. Australia is in a better position than most of its competitors. However, significant changes will be necessary to provide economic justification for capital expenditure, not just new capital but also what we call "sustaining capital" – the capital necessary to keep going.

Major world coal exporters 1987 & 1986



The open cuts in Australia, most of which are in Queensland, are in a better position and, if the underground industry does not change significantly in the next five years, the open cuts in Queensland and Canada will steal the market. Nor can we discount the efficient US east coast producers, especially if exchange rates move against Australia.

Fundamentally, we have to realise that a bad ore body, like a bad wine, does not improve with age. We have some good ore bodies but we have not reaped the maximum benefit for a number of reasons, the greatest being government regulations and imposts and poor work practices, and nowhere are they worse than in the Hunter. I believe there is a mood abroad for change, with politicans and bureaucrats realising that NSW has simply not developed as has Queensland. Maybe others are also becoming aware of this fact.

I think it is important to realise that sometimes the fundamentals of the mine are confused with the economics of the company, so while the company may get into dire straits, the mine will not necessarily close. It might change significantly, and I think the South Blackwater Mine sold recently by CSR is an example.

The losers will be the companies and the workforces which are reluctant or unable to change. The winners will be those who do change. Unfortunately for NSW, the Queensland unions seem, at this stage, more inclined to do so. It is possible to secure earnings and therefore employment, but that will not occur if profits are poor and the best new equipment is not introduced.

KCC proposed a number of practices for its underground workforce:

- an average of four nine-hour shifts a week;
- 12 days' work in a 21-day cycle;
- 9 days off in 21 days, including every Sunday off and two four-day breaks;
- ability to produce coal 51 weeks a year;
- ability to work voluntary overtime on Sundays as necessary.

Our estimate is that earnings would improve from this arrangement. Hardly draconian stuff, I would have thought.

However, the men chose to stay with a five-day week and seven-hour shifts. Six-day, 51-week production was introduced in January 1989. Two years ago I started using the phrase "an economic juggernaut is going to sweep through this industry." It has, and still has a few

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laps to go. I believe the Queensland, NSW and Federal Governments are realising the error of their ways. They killed the goose that laid the golden egg.

Now they are looking closely at both the direct and indirect charges on the industry. The Federal Government is also realising the shortsightedness of excluding a significant industry from the mainstream of industrial relations. NSW started to wind back its charges last year; it was a good start, but more is necessary.

While continuing to tick off the losers and winners, I think it is important to realise that with any commodity the customer always does OK. Sure, there might be temporary shortages but then they diversify and eventually, when the balance is restored, they are able to take some of the efficiency gains. It is important to realise that the industry does not operate in isolation. The US alone produces about 900 million tonnes of coal, and in the past it has had an ability to act as a swing supplier and bring on dormant tonnage or cut back. That will always be the case. Europe is a significant producer of subsidised coal and if we don't get our act together, they will slow that rationalisation process.

Many analysts have written their views on what coal prices should be and, frankly, those numbers never cease to amaze me. Nor does the pace at which they change. Most people accept that oil price is affected by supply and demand, but somehow coal is perceived as different. Exchange rate rises and falls in a short term do not change the price. Prices change because of demand and supply. Supply, if it is affected by the exchange rate, will eventually alter the price. Prices will not change because analysts say so or because bureaucrats or unions desire it. They change because of market factors.

And don't blame the Japanese steel mills for all our woes. The mills have helped build the Australian coal industry – and our problems are in significant part due to our own shortcomings in Australia.

Kembla coking coal is loaded into a bulk carrier bound for Brazil . . . will open-cuts steal the market?

The other players in the winners and losers:

China: can't agree whether to be a player or not. But China is predominantly a steam-coal producer, not coking coal, and will have a significant requirement for coking coal for its own steel industry.

Russia: in my opinion, forget it in the short to medium term.

Poland: is a significant player, but is exhausting its own production, as I recall, at the rate of 5 million tonnes a year. I don't think Poland has the ability (capital or reserves) to replace that sort of production. Export to the Western world will ultimately suffer.

South Africa: is really only a player in fuel coal and semi-soft coking coal. This is not likely to change because of non-availability of suitable coal.

Canada: is going through tough times at the moment, but will always be significant – especially the "older" Canadian producers. The newer Canadians will have difficulty competing in the longer term.

United States: is a huge producer which, especially if exchange rates move in the US's favour, can still be very competitive in a number of markets. Productivity is continuing to improve dramatically. Domestic demand plays an important part and most producers have only a minority of production going to export.

Another significant fact which affects us is steel intensity. There is a tendency to say that as nations develop they use lighter, thinner materials which last longer; so steel intensity decreases. A European steel consultant explained recently that the Mercedes will use much less steel. My view is that the average person in Thailand or the Philippines is more interested in galvanised roof material than the amount of steel in a Mercedes, and there are a lot more roofs built than Mercedes.

To summarise, in the export market for coking coal, the "final five" appear likely to be:

- Queensland open cuts.
- Efficient US East Coast producers.
- South Coast undergrounds.
- Hunter open cuts.
- Older Canadians.

But there will have to be a change in the way we underground producers play. □

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