ANZ Commodities

Coal prices let-off steam

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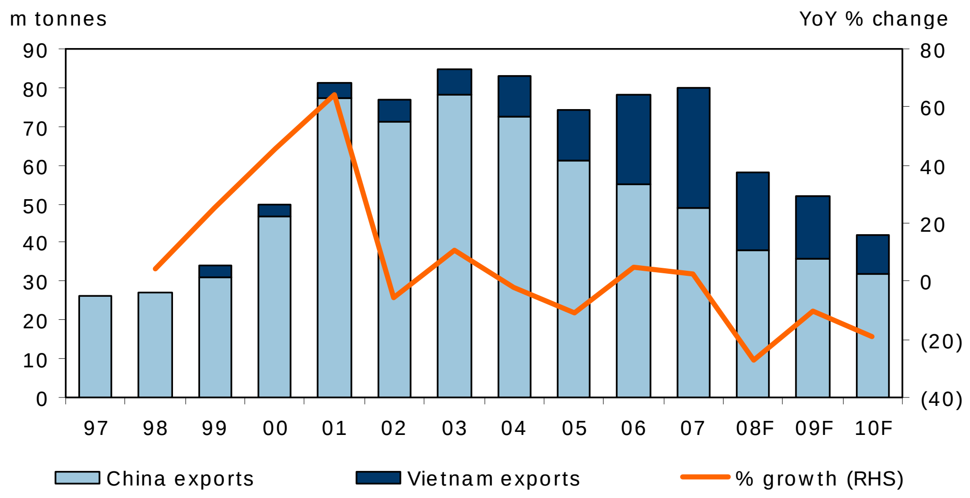
Fundamentals still strong

- Spot thermal coal prices have fallen an average 16.5% in the past five weeks tracking a 21% fall in oil prices. The price drop has prompted us to trim our contract 2009 price forecast from $165/t to $155/t – more from negative sentiment towards oil than a change in fundamentals.
- In fact, we believe the thermal coal market fundamentals could get stronger, with constrained supply conditions in Australia and South Africa met by booming demand in Asia. The pinch will come when China and Vietnam move from net exporters to net importers of coal in the next 12-24 months.
- That pinch may come sooner for China, with reports today that China will impose a 10% export tax on thermal coal from 20 August. The tax imposition appears to be a strategy to boost low domestic coal stocks by closing the gap between domestic and international coal prices.
- There's also rising expectations that China will lower its second batch of 2008 coal export quota's from 22mt to as low as 10mt. An announcement is expected after the Olympics, which on top of higher export taxes, will put extra stress on an already tight seaborne coal market.
- And super high semi-soft coking coal prices - recently bumped higher by Rio Tinto and Xstrata – means Australian thermal coal exports will struggle to rise as producers continue (if not even ramp-up) high CV thermal coal into the much better-priced coking coal market.

Figure 1: China and Vietnam thermal coal exports



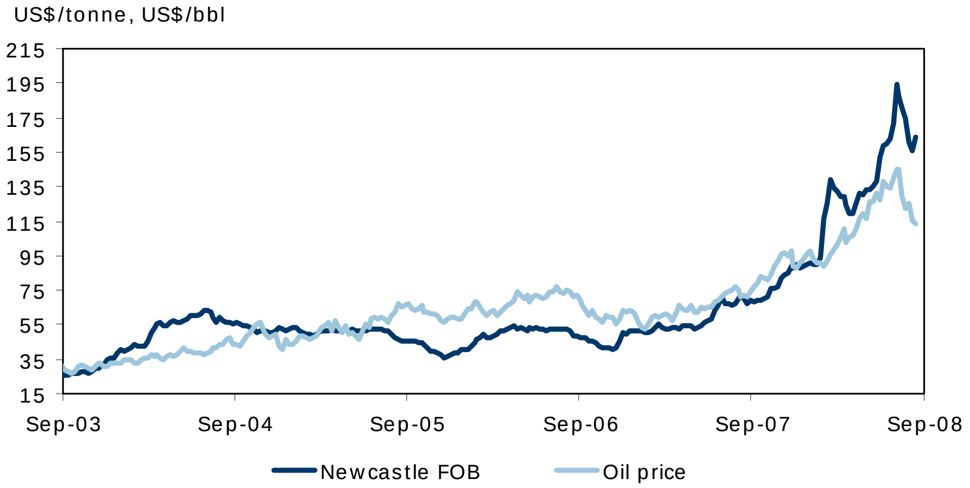
Source: AME, ANZ

Price correction warranted

Well-earned profit-taking

Newcastle spot thermal coal prices have fallen 16.5% or $35/t in the past five weeks as cooling sentiment in an overheated oil market triggered a similar re-think in a super-strong coal market. We think the coal price fall looks warranted having tracked oil on the way up - and with our 14% downgrade in oil prices for 2009, we have decided to trim our 2009 contract thermal coal price by 4% to $155/t. Despite the lower 2009 coal price forecast (still rising 25% on 2008 contract prices), we see the price risk on the upside, with inelastic demand conditions being met by potentially tighter supply conditions over the next 6-12 months.

Figure 2: Coal and oil prices

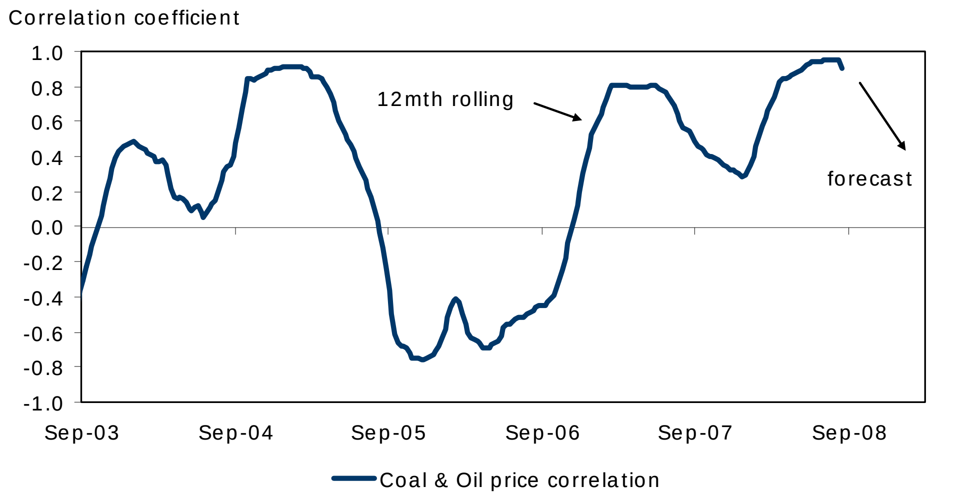


Source: Bloomberg, globalCOAL

Coals correlation to a falling oil price to decline in the next six months

Not surprisingly, the thermal coal's correlation with oil has been very strong over the past six months, with higher oil prices buoying all energy markets. Unfortunately the relationship has worked both ways. The positive rub, is that the strong correlation may be about to end (at the benefit of coal). Although both are energy products – oil is much more leveraged to a weakening transport market (55% of western world end-use) - compared to a much more buoyant emerging electricity market (predominately China) for thermal coal (80% of end-use).

Figure 3: Correlation between coal and oil

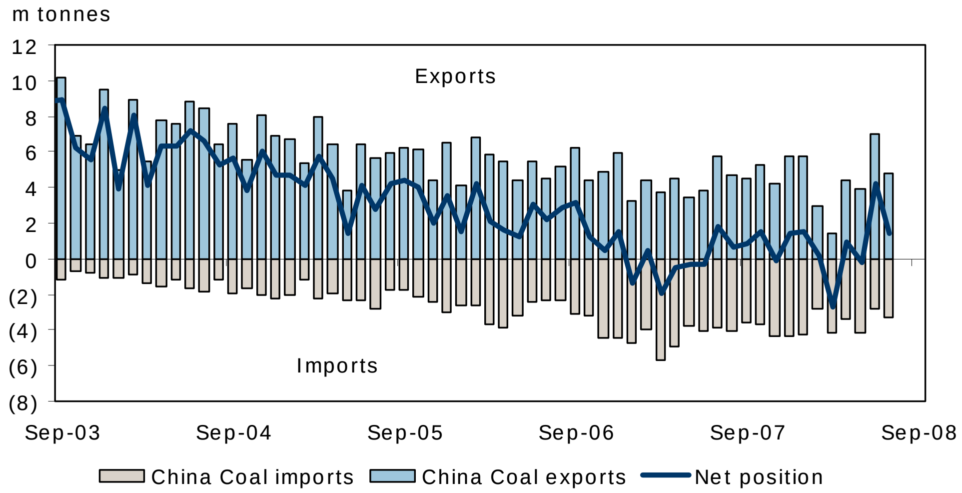


Source: Bloomberg, globalCOAL

Chinese coal export quotas to fall further

China's net coal exporting position will have a big influence on market sentiment and prices in the coming months. In March, the Chinese government reduced its annual coal export quotas from 70mt to 53mt to help boost low domestic supply levels. The first batch of quota's totaling 31.8mt were taken up quickly, with China moving back into a net coal exporting position in the past couple of months. Reports suggest the second implied batch of 21.2mt will be reduced to 10-15mt because of worsening domestic coal supply. Numerous reports suggest the bulk of the Chinese power industry is operating with less than seven days of coal supply (with 20 days being a more normal operating level).

Figure 4: China coal exports and imports

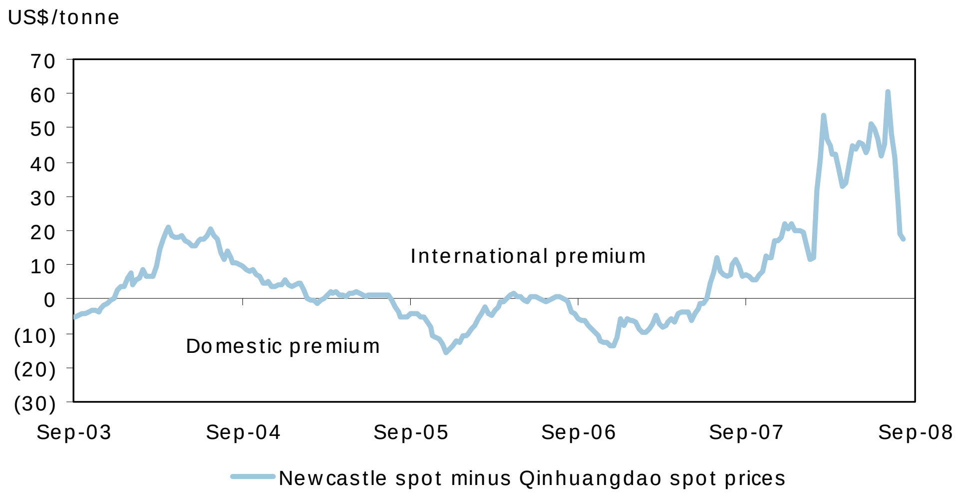


Source: China Customs

Narrowing coal price spreads should push China back into a net coal importing position

Part of the problem is higher more attractive international coal prices. The widening spread between the benchmark Asian Newcastle spot price and the China domestic Qinhuangdao coal price over the first half of 2008 has triggered a rising trend in China coal exports (despite booming domestic demand). Recent price caps on domestic coal prices hasn't helped– in fact, has exacerbated the problem. Reports today that China will impose a 10% export tax on coal from 20 August together with a sharp drop in the price spread over the past four weeks, could see China's move back into a net coal importing position in the coming months (buoying international coal markets).

Figure 3: Spread between Qinhuangdao and Newcastle coal prices



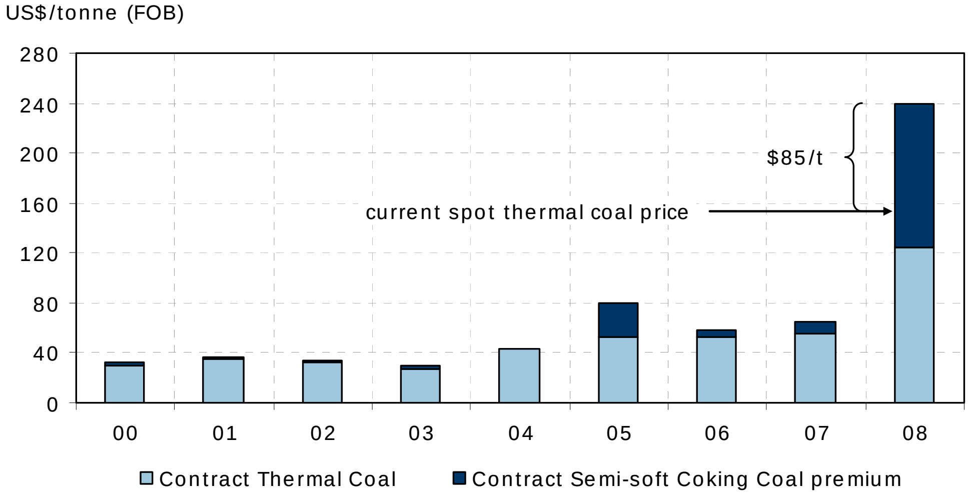
Source: CEIC, globalCOAL

Upgrade of high CV thermal to semi-soft coking will continue

The transfer of high CV thermal coal into the much higher priced semi-soft coking coal has given additional price support to thermal coal this year. Historically the contract price spread between the two coal types has been about $3-5/t (in favour of coking coal). However, the spread rose to $26.5/t in 2005 when China pulled back sharply on coking coal exports then ballooned out to a stellar $115/t this year after the major Queensland coal mine floods in January/February.

Reports suggest it costs about $20-25/t to wash and beneficiate high CV thermal coal into semi-soft coking coal. The latest spread between Newcastle spot prices and the recently struck Xstrata and Rio Tinto contract semi-soft coking coal price of $240/t has increased to a very healthy $85/t after closing to about $35/t spread five weeks ago (using the earlier struck $230/t contract semi-soft coking coal price of BHP Billiton). Accordingly, we still see a large incentive to upgrade high CV thermal coal into the semi-soft coking coal market.

Figure 4: Thermal and semi-soft coking coal prices



Source: AME, globalCOAL, ANZ

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