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Summary – thermal prices firm on tight spot market, as China's demand continues to influence coal markets

- **Thermal coal markets firm…:** Strong demand from Asian consumers and supply constraints in key exporting nations have led to a rebound in spot prices for thermal coal in recent months.
- The diminishing export position of China has lead to Korean and Japanese consumers – primarily in the cement industry – seeking alternative supplies.
- At the same time, heavy rain in Indonesia and a growing vessel queue at Newcastle has limited the capacity of coal producers to respond.
- **…and may influence contract negotiations:** The tight market conditions have emboldened Australian thermal coal producers – encouraging them to seek price upgrades for the 2007 Japanese financial year.
- With some of the tightness related to short term factors – particularly disruptions in Indonesia – we have revised our forecast price to US$52.50 a tonne, a rollover of current contract prices (see page 3).
- Semi-soft coking coal prices are expected to settle in line with thermal – with a traditional premium for higher energy content – at around US$56.40 a tonne, a decline of 2.8 per cent.
- Contract prices for hard coking coal have already been settled with Japanese steel mills – with premium grade coal settling at US$98 a tonne, a decrease year on year of around 15 per cent.
- **Asia continues to drive coal demand…:** Asia remains the key growth region for coal imports – reflecting the strength of economic growth driving increasing demand for electricity and steel, as well as the lower levels of environmental regulation (see pages 3 and 4).
- Growth opportunities for both thermal and metallurgical coal revolve around China and India. While both countries are major coal producers, domestic demand continues to rise – straining the capacity of producers in both countries.
- **…while supply growth is likely from Australia and Indonesia:** Indonesian exports have surged in recent years, benefiting from constraints in other major exporting nations – such as Australia and South Africa – and the declining trade position of China.
- As constraints at the port of Newcastle are unwound, Australian coal exports are forecast to rise, albeit gradually. Thermal coal exports are forecast to increase by 6.4 per cent to 117 million tonnes.
- **China's role in global markets remains a major issue:** Since 2003 – the peak year for the country's coal exports – China's almost insatiable demand for energy has effectively removed 58 million tonnes of coal from global markets (see page 2).
- Our base case forecasts China's net exports to fall from 25 million tonnes in 2006 to around 10 million tonnes by 2008. Should China become a net importer, this would add upside risk to coal prices.

Summary of forecasts

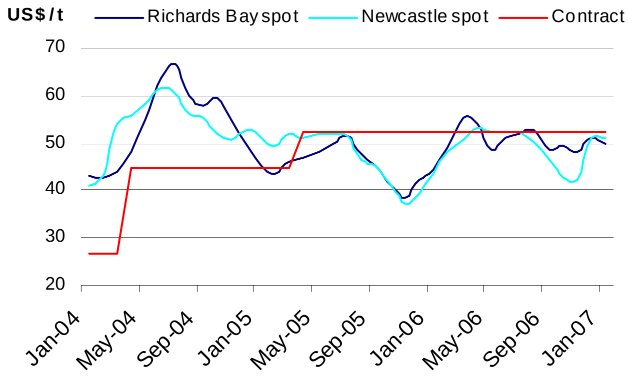
	2005	2006 e	2007 f	2008 f
Global trade – Mt				
- Thermal	571.2	609.5	632.2	651.9
- Metallurgical	218.7	224.9	231.0	237.7
Contract price – US$/t				
- Thermal	52.50	52.50	52.50	48.00
- Semi-soft coking	85.00	58.00	56.40	51.60
- Hard coking	125.00	115.00	98.00	88.00

Source: ABARE, NAB Group Economics

Feature: Thermal market tightness may lead to protracted negotiations

Asian thermal coal prices rebounded sharply in late 2006 as a range of supply disruptions tightened markets, despite mild winter conditions that limited coal burn. Coal supply from China, Indonesia and Australia has been constrained – leading consumers to enter the spot market. Spot prices for thermal coal at Newcastle have risen sharply – from an average of US$42.36 a tonne in November to US$51.05 a tonne in January (globalCOAL).

Tight markets drive up thermal prices at the end of 2006



Source: globalCOAL, ABARE

Coal mine explosions in China's Shanxi province during December limited the country's export supply, with long term contract consumers in both Japan and South Korea – primarily in the cement industry – receiving reduced shipments. Consumers in China have also reportedly sought cargos from Australia to cover the shortfall in domestic supply (Platts).

Indonesian producers have also been hampered by heavy rain in December and January. The rains have limited production in the key regions of East and South Kalimantan and Sumatra, and restricted the capacity of producers to respond to increased demand.

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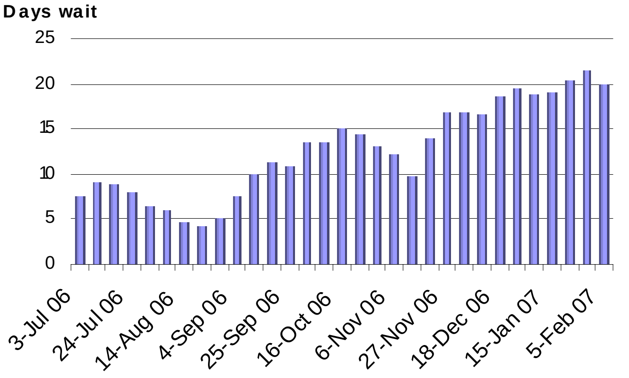
Vessel queues at the port of Newcastle have also increased, particularly following the end of the controversial Capacity Balancing Scheme. In January, the vessel queue was around 50 ships, with waiting times exceeding 20 days by the end of the month.

Queues at Newcastle extend from late 2006



Source: Reuters

Expansions at the Newcastle port facility are scheduled for completion at the end of the first quarter – both the start of the new Japanese financial year and a period of seasonally lower demand.

The tight conditions have emboldened Australian coal producers, with preliminary contract negotiations targeting a price rise for the 2007 Japanese financial year. Reports suggest some major producers have offered volumes at US$54-55 a tonne (Platts) – compared with US$52.50 a tonne in both 2005 and 2006. Consumers are more than likely to seek a reduction.

Given that the market balance may move in favour of consumers in coming months – as disruptions are resolved and demand diminishes from peak winter levels – negotiations between Australian producers and Japanese utilities may be protracted. We have revised our price forecast to a rollover for 2007 (see below).

Historically other Asian consumers – particularly major coal users such as South Korea and Taiwan – wait for the Japanese settlement before negotiating their own contracts. However, Korean settlements in 2006 – well before their Japanese equivalents – may signal a less structured approach to thermal coal contractual arrangements in coming years.

China's influence is not to be overlooked

China's domestic coal production continued to grow in 2006 – cementing it's role as the world's leading coal producer – with raw coal output increasing by 8.1 per cent to 2.33 billion tonnes (excluding output from unregistered mines) (SACS). Yet despite another record production figure, China's trade position continues to evolve – as exports shrink and imports build.

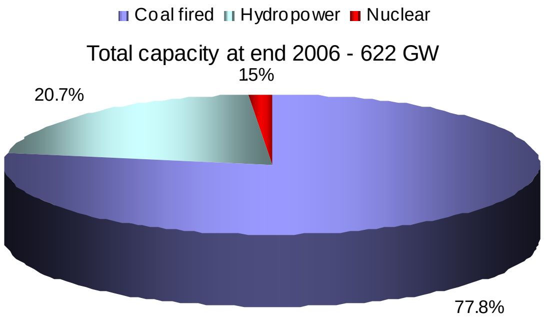
China's net exports plunge as domestic demand takes precedence

Source: CEIC, NAB Group Economics

In 2006, China's net exports continued their three year downward trend, plunging to just 25 million tonnes. Since 2003 – the peak year for the country's coal exports – China's almost insatiable demand for energy has effectively removed 58 million tonnes of coal from global markets.

Surging domestic demand – primarily from the electricity generation sector – has led to a domestic premium in coal prices and lower exports. China's government has also reduced the tax incentives for exports over domestic sales. Coal fired generation accounted for around 83 per cent of electricity generation in 2006 (Reuters).

Coal dominates electricity generation capacity



Source: Reuters

According to reports in January, China's National Development and Reform Commission intends to cap coal output to 2.6 billion tonnes in 2010 – a level which the agency forecasts will be equivalent to the country's demand (AFX). In order to accomplish this target, the NDRC intends to establish a series of large scale coal mining companies which are intended to produce around 50 per cent of this output, while closing around 8000 small coal mines. The State Administration of Coal Mine Safety intends to close 2209 mines in 2007 alone (Platts).

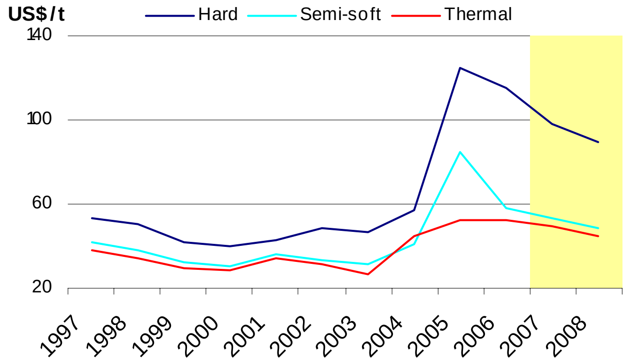
These moves may signal an intention to reduce China's involvement in global coal trade. Our base case forecasts China's net exports to fall from 25 million tonnes in 2006 to around 10 million tonnes by 2008. Should China become a net importer, this would add upside risk to coal prices.

However, China's trade position is a fraction of production – exports totalled less than 1.1 per cent of output in 2006 – suggesting even a modest change in domestic consumption could have a major impact on global coal markets. Developments in China will remain a major watch issue for the coal industry.

Coal contract prices – hard coking settles lower, but thermal settlements may be far away

Hard coking coal settlements were reached quickly in mid-December, with Nippon Steel securing premium hard coking coal brands for US$98 a tonne FOB (Platts), broadly in line with our forecast of US$100 a tonne. This price represents a decline in prices of around almost 15 per cent – reflecting weaker market conditions with more readily available product.

Coal prices trend lower, but remain historically high



Source: ABARE, NAB Group Economics

As discussed above, contract negotiations for thermal coal are likely to be protracted – with producers seeking a price increase, and consumers seeking a reduction. We believe there is a risk of the latter – if growth in capacity is sufficient to shift the market balance into surplus.

However, given current market tightness, we are revising up forecast contract prices to US$52.50 a tonne FOB (previously US$46) – a rollover of current contract prices for the second straight year.

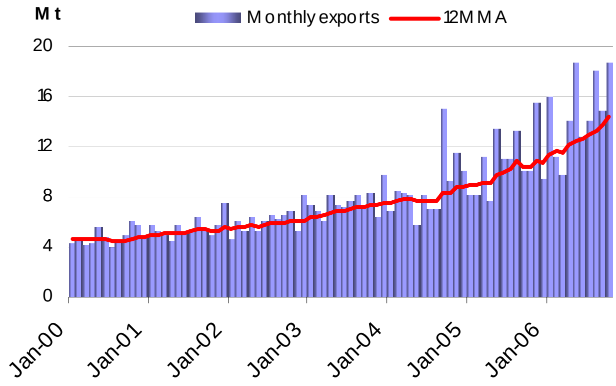
Prices for semi-soft coking coal are also likely to be delayed by thermal negotiations. Typically these prices are settled with a premium to thermal – reflecting the higher energy content of semi-soft coal. Coal producers are unlikely to seek an earlier settlement, given the outcome in 2004 when earlier settled semi-soft coal was sold at a discount to later settled thermal.

As a result, semi-soft coking coal prices are forecast to fall by around 2.8 per cent to US$56.40 a tonne FOB.

The supply side – Australia and Indonesia offer growth, but China set to decline further

Indonesian exports have surged in recent years, benefiting from constraints in other major exporting nations – such as Australia and South Africa – and the declining trade position of China. In the first ten months of 2006, Indonesia's total coal exports increased by a staggering 43 per cent to 148 million tonnes, exceeding Australia's thermal coal exports (CEIC).

Indonesian exports continue to trend higher



Source: CEIC

Despite infrastructure constraints, rising diesel prices (following the abolition of subsidies) and relatively low quality, Indonesian coal exports are forecast to gain further in 2007, to reach 175 million tonnes.

In the medium term, growth in Indonesian exports is likely to be constrained by increased domestic demand. Indonesia's State Electricity Company plans to rapidly increase coal-fired generation capacity in response to power shortages and rising oil prices.

As constraints at the port of Newcastle are unwound, Australian coal exports are forecast to rise, albeit gradually. Thermal coal exports are forecast to increase by 6.4 per cent to 117 million tonnes.

On the metallurgical coal front, Australia is likely to be the key growth exporter in the short term. Exports appear to have slowed in 2006 – in response to increased domestic availability in China – but are forecast to increase by around 6.5 per cent to 131 million tonnes.

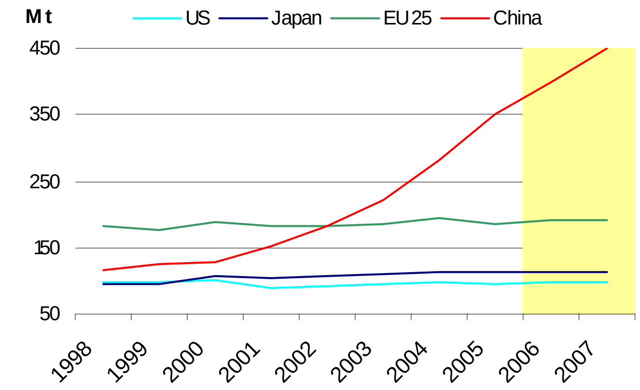
Coal exports from other major exporters are forecast to remain relatively unchanged – with the exception of declining volumes from China (see above).

Coal demand – Asia remains the key

Asia remains the key growth region for coal imports – reflecting the strength of economic growth driving increasing demand for electricity and steel, as well as the lower levels of environmental regulation.

Growth opportunities for both thermal and metallurgical coal revolve around China and India. While both countries are major coal producers, domestic demand continues to rise – straining the capacity of producers in both countries.

China's surging steel production still the main coking coal driver



Source: IISI, NAB Group Economics

Despite massive coal reserves, China's supply of hard coking coal is insufficient to meet the growing demands of the country's steel industry. Steel production is forecast to increase by around 12 per cent in 2006, requiring imported coking coal to support this growth. China's metallurgical coal imports are forecast to increase by 25 per cent in 2007 to 9.0 million tonnes.

Similarly growth in India's steel production will also be supported by imported coking coal. India has only modest reserves of metallurgical coal, which are primarily semi-soft quality. Indian coking coal imports are forecast to increase by 19 per cent to 24 million tonnes.

Imports of metallurgical coal in other major regions – such as Japan and the European Union – are forecast to remain relatively flat, reflecting the modest growth expectations for steel production in the short term.

Thermal coal trade forecast

	2005	2006 e	2007 f	2008 f
Total trade - Mt	571.2	609.5	632.2	651.9
Key importers				
- Japan	115.2	115.0	116.2	116.0
- South Korea	60.6	63.0	66.0	70.2
- Taiwan	55.2	57.8	60.0	62.0
- China	22.0	27.2	34.2	38.2
- India	18.2	31.0	36.0	37.0
- European Union	157.2	159.0	160.5	162.0
Key exporters				
- Australia	107.6	110.4	117.5	125.0
- China	63.1	58.2	55.2	52.4
- Indonesia	123.3	170.0	175.0	180.0
Contract price – US$/t	52.50	52.50	52.50	48.00

Source: ABARE, NAB Group Economics

Metallurgical coal trade forecast

	2005	2006 e	2007 f	2008 f
Total trade - Mt	218.7	224.9	231.0	237.7
Key importers	65.6	67.1	67.4	67.0
- Japan	18.3	18.6	18.0	18.2
- South Korea	18.0	20.5	24.4	25.2
- India	7.2	7.2	9.0	10.0
- China	59.5	60.0	59.5	61.2
- European Union	15.8	17.8	19.9	22.0
- Brazil				
Key exporters				
- Australia	124.9	123.0	131.0	135.0
- Canada	27.8	31.1	34.0	35.3
- United States	26.0	25.8	20.0	18.0
Contract price – US$/t				
- Semi-soft coking	85.00	58.00	56.40	51.60
- Hard coking	125.00	115.00	98.00	88.00

Source: ABARE, NAB Group Economics

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