7 June 2000 - Open briefing - interview with Michael Chaney - value of coal acquisition

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You have just paid A$200m including working capital for the Curragh coal mine in Queensland. What was the original capital cost to develop the mine to its current output?

CEO Michael Chaney
The original capital cost was in excess of $600m and therein lies one of the real attractions of the acquisition. We're acquiring the assets for well below replacement cost. At that level of entry price, it has the potential to provide an attractive return.

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Why has the sale process been protracted?

CEO Michael Chaney
In 1997 there was an extended and costly industrial stoppage at the mine which eventually resulted in a complete revision of work practices and industrial arrangements. After those issues had been resolved, Arco put the mine back on the market and then the sale process proceeded according to a normal schedule.

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What is the state of the mining equipment and what is the sustaining capital requirement for the mine per annum?

CEO Michael Chaney
The equipment is in very good condition including all 5 draglines.

The ongoing capital requirements are quite minimal. We will be expending some capital to enhance productivity and to optimise the use of the existing equipment. But there's nothing in terms of significant capital items.

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Returns from the Australian Coal Industry have been notoriously poor. How will you achieve your hurdle rate on this investment?

CEO Michael Chaney
Taking an average across an industry is always fraught with difficulty. In Australia, there are some very profitable coal mines and some very unprofitable ones.

The investment returns are a function of acquisition cost versus the net cash inflows over time. At the price we're paying we estimate that we will exceed, not just meet, our hurdle rate.

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The acquisition cost of $44 per tonne of coal sold is favourable when compared with other recent transactions. Do you think the macro picture will turn, or are your relying on expansions and productivity improvements to reach your investment goals?

CEO Michael Chaney
In carrying out our investment analysis, we took a fairly conservative view of future coal prices. Traditionally, those forecasts have been hard to get right. Nevertheless, we believe that the outlook is quite positive. In all likelihood, there will be increases in coking and steaming coal prices in the coming years; certainly some industry analysts are predicting that. Movements in spot coal prices and iron ore prices and the prices paid for some other coal assets also support this view.

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Projected sales for this year are 4.7 million tonnes. What is the current capacity of the operation?

CEO Michael Chaney
The capacity is quite a bit higher than that. Our expectation is that we'll produce about 4.7 million tonnes of saleable coal in FY2001 and then progressively rise to about 5.5 million tonnes 3-4 years later. We can achieve that growth in production with very limited additional capital investment.

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In your ASX release announcing the acquisition, you mentioned the percentage breakdown of product as 50% domestic steaming coal and 50% export coking coal. Of the export coking coal, what is the rough split between hard and semi-soft coking coal?

CEO Michael Chaney
For competitive reasons, it's not in our interest to answer that precisely. But I can say, as we expand in the next 3-5 years, the proportion of the higher value hard coking coal will rise and the proportion of semi-soft and PCI coal will fall. This is one of the reasons we anticipate profits to increase.

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In percentage terms, can you reveal the price adjustments to Curragh coal after the recent negotiations?

CEO Michael Chaney
Curragh export coal prices were adjusted in line with contract prices in the industry.

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What are the main characteristics of the different types of coal Curragh produces?

CEO Michael Chaney
All Curragh's products are well regarded within their category.
Curragh's hard coking coal is low in ash content which facilitates blending with coals from other sources while still meeting with the stringent demands of Japanese steel mills. The other characteristics of Curragh coal are well within typical guidelines for their respective product categories.

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Is it correct to conclude that should the trend to a higher use of PCI steel making continue, then the demand for your semi-soft coking coal will increase but demand for your hard coking coal may suffer?

CEO Michael Chaney
An increase in PCI coal usage in steel making would have a negative impact on hard coking coal consumption. But the impact is at the margin and not one that is going to have a large affect on us in the years ahead. Bowen Basin coking coals are among the best in the world and good quality hard coking coal such as Curragh's will always be in demand.

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The gradual move away from a benchmark pricing system over the years means each producer requires a marketing team experienced in export coal markets. Have you inherited a team, or is a marketing team something you need to build?

CEO Michael Chaney
Curragh has a first rate sales team and they have got a very good reputation for marketing the coal. The team has successfully rebuilt sales volumes in the past couple of years in what is a pretty depressed market. We're confident that trend can be maintained and we plan to retain all members of the coal sales team.

Our marketing people negotiate directly with customers but Curragh's prices are still heavily influenced by prevailing market prices.

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Almost all of Curragh's steaming coal is sold domestically to the Stanwell Power Station. Is this contract profitable?

CEO Michael Chaney
I'm not prepared to discuss any specific contract for obvious reasons but we're satisfied with the terms of the Stanwell contract.

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Some broking reports have referred to 'geotechnical' issues at the mine. Can you explain any such issues and how they will be addressed?

CEO Michael Chaney
No. I haven't been able to understand those comments. I've read one or two things and they haven't been specific.

Some reports incorrectly stated stripping ratios of 12-13 to 1. The actual prime stripping ratio is about 7 to 1 and the 12 to 1 refers to a ratio that includes dragline rehandle.

There is some faulting within the mine but the resulting blocks are large. The dragline and other equipment operators are very experienced and they handle the faulting without any problem.

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Queensland coal producers have recently received cuts in rail freight rates from the government. Are more cuts in store or has this negotiation process concluded?

CEO Michael Chaney
No, this is far from concluded. Later this year, the rail freights for Curragh are due to be renegotiated. This should add further to unit cost savings. We've already achieved pretty good savings in freight rates from our Bengalla operation in NSW.

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The Curragh purchase increases Wesfarmers' commodity price and exchange rate risk. Have you inherited a foreign exchange book as part of the transaction and will you be hedging any exchange rate exposure?

CEO Michael Chaney
We have not inherited a foreign exchange book.

However, we have already carried out our own A$ hedging. This covers a reasonable proportion of the export production for the first five years of our ownership, at exchange rates below that used in our acquisition analysis.

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Production at the mine was crippled in 1997 due to industrial action. You've mentioned the mine now has flexible workplace arrangements. Can you explain what you mean by this and how productivity gains may be secured?

CEO Michael Chaney
The working arrangements are very flexible as multi-skilling arrangements are in place. There are no demarcation issues at the mine. For example, an operator will hop off one piece of equipment and operate another while somebody is on their break.

In terms of increases in productivity, we haven't factored anything from improved work practices. All of the employees are on merit-based remuneration and work efficiently.

We will achieve increased profitability from higher production, a higher value product mix and from some unit cost savings which we expect to flow from some of those minor capital expenditure items I mentioned earlier.

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Thank you Michael, we look forward to the next Open Briefing with Wesfarmers.