INSIDE CHINA

A WEEKLY SERIES LOOKING AT THE BIGGER PICTURE

TODAY COAL SECTOR

Small mines getting back to business

Shutdowns to encourage mergers and better safety standards see output fall equal to coal imports

A major prop for global coal prices this year quietly expired recently, the deadline for small, dangerous mines in the country's top producing province to merge into larger operators.

But analysts warn not to expect a quick supply filip after the August 31 deadline for mines in Shanxi to join forces to be allowed to reopen, as the process of consolidation and continued pressure on the sector's appalling safety record constrains output.

Shutdowns in Shanxi earlier this year were a lucky break for coal suppliers in Australia, Indonesia and Vietnam, helping turn China into a net importer just as the global financial crisis demolished demand from other countries.

Now the province, the source of 25 per cent of China's coal, is poised to let many small mines reopen.

But a recent fatal explosion at a mine in Shanxi underlines that progress on safety is far from assured, while mines may be slow to return to normal production after the enforced mergers.

"Signing a framework agreement for a merger is much easier than actually finalising the price of the deal," said Wang Ye, an analyst at Citic Securities. "It's easy to get engaged, but marriage is a totally different matter."

Small mines contribute about 33 per cent of Shanxi's coal output. For coking coal, the more valuable grade used by steelmakers, small mines contribute even more, as most coking coal resources are controlled by small mines, analysts said.

As the consolidation drive got under way after a major mine blast in late February, production from Shanxi failed to show the typical sharp recovery from the Lunar New Year holiday trough.

Output for Shanxi in the first seven months fell 42 million tonnes or 12 per cent to 318 million tonnes – a decline almost equal to the huge rise in imports that flipped China from a net exporter to a major net buyer of coal.

The world's top producer and consumer shipped in nearly 50 million tonnes net of coal in the seven months to July, compared with 4.7 million tonnes of net exports in all of last year.

"The major bullish case for thermal coal from a China perspective has been the supply constraints in Shanxi," said Scotia Capital China strategist Na Liu in a note to clients.

But with the mergers now having taken place, this bullish factor for global markets could be removed.

The shutdowns hit Shanxi hard, making it the only province to see its economy shrink in the first half of this year. That could prompt local officials to take a more lenient view of restarts at small mines, which make up 80 per cent of the province's total.

One of country's top power producers, Huadian Power International Corp, expects Shanxi to produce 400 million tonnes of coal in the second half of the year, about 60 per cent more than in the first half and about 17 per cent up from the same months last year.

If that proves accurate, Shanxi would pump enough coal into the market to deflate the appetite for imports. Liu said a third of Shanxi's output would be coking coal, so the impact would not be confined to the thermal coal market.

While the pace of output in Shanxi has been picking up since its low in January, it is not clear that this can be maintained.

"The fast growth we've seen in the past few months is not going to be sustainable," said Citigroup analyst Pierre Lau.

Illustration: Lau Ka-kuen

In the short term, the central government may keep a lid on further expansion before the October 1 anniversary of the founding of the People's Republic of China, Lau added.

"Safety will be the focus before October 1. I won't be surprised to see growth in Shanxi's coal output slow down a bit," he said.

The hilly province in the north, occupying less than 2 per cent of the country's territory, produced 25 per cent of China's coal last year. As well as a soot-blackened landscape and mine blasts that kill dozens or more every year, the booming coal industry has created a class of newly rich Chinese, conspicuous in their Hummers and Mercedes.

But standards have yet to show much improvement. Last week, an explosion at a mine being built in Shanxi killed 14 miners just as a month of nationwide safety inspections was launched.

"The accident will definitely affect small mines and those mines currently under construction," said an industry official in Shanxi, who expects production restrictions for the next month.

And the crackdown on small mines is not over. Shanxi still wants to cut the number from 2,600 now to 1,000 by the end of 2010.

To sift out the smaller, less efficient operators, it will raise the minimum mine shaft capacity to 900,000 tonnes of coal a year from 360,000 tonnes today, a government document showed.

In addition, many small mines are expected to go through expansion and upgrading work, which will take as long as a year or two, China Merchants Securities analyst Lu Ping said. "At the current stage, big companies are just carving up the province's coal resources."

Big state-owned companies including coal miners and power producers are rushing to buy the small mines. Shanxi Coal Import & Export Group and Shanxi Coal Transportation and Sales Group, which do not yet produce a tonne of coal, both have the ambition of hitting 50 million tonnes a year, local media reported.

Reuters

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Steel product imports expected to rise 10pc from stimulus-driven demand

Bloomberg in Beijing

China, the world's largest steel consumer, may increase product imports 10 per cent this year as a government stimulus bolsters manufacturing and building demand, a research affiliate of the Ministry of Commerce said.

Shipments may rise to 18 million tonnes, Chen Kexin, a senior economist at China Commercial Distribution and Productivity Promotion Centre, said recently in Shanghai. That would be the first gain since at least 2004, Bloomberg data shows.

"China still can't make enough top-end steel products by itself although it has some overcapacity for lower-end outputs," Chen said while attending a conference.

China's steel demand is leading a global revival, with mills from South Korea's Posco to India's Tata Steel raising output as the industry pulls out of a slump. Higher imports by China may help to ease trade tensions with the United States, which has accused the Asian nation of subsidising mills.

Chen's centre provides commodity market research to the Chinese government. Chen said his comments represented the views of his company and not the commerce ministry.

Imports rose 1.6 per cent to 9.88 million tonnes in the first seven months, Chen said. Steel product exports will plunge more than 60 per cent to 20 million tonnes this year, he said. Shipments overseas may gain 10 per cent next year, he said.

The mainland became a net crude-steel importer for the first time in three years in March as the government's four trillion yuan (HK$4.54 trillion) stimulus spending spurred domestic demand even as exports collapsed.

The country will consume 600 million tonnes of steel next year, Chen said.

"China will have 10 to 20 super cities, each with populations of more than 10 million people," Chen said. "That will keep demand above 600 million tonnes over a long period."

Rising steel supply and a price surge earlier this year have led to a 17 per cent decline in benchmark Chinese steel prices in the past four weeks.

"There will be price corrections, even deep corrections, but the overall trend is up because of the demand from China and the recovering global economy," Chen said. The so-called overcapacity in the country's steel industry was not "as bad as people have imagined", he said.

Mills have been operating at about 80 per cent of capacity this year, which is "healthy", he said. Industry Minister Li Yizhong last month ordered the steel industry to refrain from expanding capacity. Mills can produce 660 million tonnes of steel a year and there is demand for 470 million tonnes, Li said.

Management with Paul Phyall

Clean mechanism not perfect but effective

When China's top climate change economists last week stuck a US$438 billion price tag on the annual cost of reducing the country's greenhouse gas emissions, capitalists and environmentalists alike got their first glimpse of the enormity of the task at hand.

A commitment on that scale will require capital resources from across the developed world and a multitude of emissions-reducing initiatives, not least of which will be national commitments to the Kyoto Protocol.

With the Copenhagen round less than three months away, it is easy to forget that the Kyoto Protocol, signed by 37 industrialised countries and the European Union, is nearing its 12th birthday.

Its critics argue that few signatory nations will meet their binding five-year targets to reduce their greenhouse emissions by 5 per cent by 2012 against 1990 levels.

> Politicians know how difficult it is to agree on simple tax issues, let alone a carbon tax

But the vulnerabilities of the pact's "cap-and-trade" system, known as the clean development mechanism, are better understood now, as are its benefits. That is true in China, where about 60 per cent of the mechanism scheme's carbon credits have been earned, according to the United Nations Framework Convention on Climate Change.

Aside from allowing developed economies to implement emissions-reducing projects in developing countries such as China, the mechanism was created to stimulate sustainable development and emissions reduction, by promoting renewable energy sources, for example.

Industry experts continue to question whether all clean mechanism-related projects deliver real reductions. Those concerns have proven both legitimate and beneficial to mitigation process that is still in its infancy.

And the climate change convention has acted to protect the sector's image, passing new regulations to govern the principle of "additionality", which assures that carbon credits are only awarded for mitigation projects and to stop carbon dioxide reductions from being double-counted.

It has also created stringent rules to govern the activities of designated operational entities, companies such as Lloyd's Register Quality Assurance that are certified to assess the carbon dioxide reduction value of clean development mechanism projects.

While the climate change convention should be praised for driving greater transparency into the clean mechanism process, one of the biggest concerns among project owners and their financiers continues to be the ability of designated operational entities to meet delivery deadlines.

Some opponents of the clean mechanism process argue that a global carbon tax would be more transparent and less complicated. But that is not a practical solution. Politicians of all stripes know how difficult it is to agree on simple taxation issues, let alone a complex issue such as a carbon tax.

While it is easy to criticise the clean mechanism process, it is important to note its successes. According to the climate change convention last week, there are 1,806 registered projects, about 73 per cent of them in the Asia-Pacific. Those projects are expected to offset an average of 313.1 million tonnes of carbon emissions each year until 2012, generating 1.64 billion carbon credits.

Despite its growing pains, the clean mechanism process has been instrumental in reducing global carbon emissions. No one is saying the Kyoto Protocol is perfect, and most are hoping that Copenhagen will deliver a more effective way to reverse climate change.

The clean mechanism process may not be the perfect system to help China reduce its greenhouse gas emissions. But as with what is often said about democracy: "It may not be the perfect system, but it is the best one we have."

Paul Phyall is a senior vice-president for Asia at Lloyd's Register Quality Assurance

Book Review with Samantha Kierath

Response is critical for stuck companies

Steve McKee writes from personal experience about being stuck. After 10 years in the advertising industry and as the co-founder of a leading regional firm, he had just collected an award for being one of the fastest-growing private businesses in the United States. It should have been a crowning achievement but McKee was uneasy. Back at the office, sales were down, staff were leaving and the company was failing to garner interest in its product. The firm was just spinning its wheels and nobody knew why.

So McKee and his colleagues turned to market research, zeroing in on struggling but once rapidly growing companies to try to understand why other former leading corporate lights had dimmed. The results are detailed in McKee's book, *When Growth Stalls – How it Happens, Why You're Stuck and What to do About it.*

One of the big things the author learned was that his company was normal. Irrespective of how great a firm's products, management and approach are, stalled growth is inevitable in every industry. Size doesn't matter and no company is safe. Market leaders had a better chance of maintaining growth but when the "market tectonics" shift, every company is at risk.

The upheaval can come in several forms, whether it's an economic downturn, aggressive competition or changing industry dynamics. These external factors are the business equivalent of the Rumsfeldian known unknowns and survival is determined not so much by the degree of the hit but by the quality of the response.

Just ask Kodak. The rapid switch to digital photography caught the multinational napping, but in four years the company that had built a business out of film was selling digital cameras, digital photo frames and inkjet printers.

While outside forces demand attention, management will also inevitably have to focus on the internal issues inhibiting progress. Stalled growth also has a habit of revealing internal rifts, from personal distrust to strategic doubts, and, according to McKee, "a lack of consensus is the number one internal problem" for stuck firms.

Stalled companies are also frequently diagnosed with a loss of nerve at the top. McKee says upheaval in the marketplace can have a destabilising effect on the emotions of business leaders as they try to cope with tiring and confusing conditions. Until this is tackled, firms cannot be fixed.

The first instinct should not be to hurriedly "lop off heads" but to take a deep breath and think about what success should look like. The management team – and not just the chief executive – has to agree on an overall objective to guide each employee's decisions and return the organisation to growth.

Once the "what" has been answered, attention can turn to the "who", the prospective customer. McKee says that stalled companies are more than twice as likely to admit that they have not identified a target audience.

When Growth Stalls has some useful pointers for managers trying to work out why it is that their otherwise winning formula isn't working. The handiest sections are the practical questions designed to diagnose internal fault lines, particularly on corporate focus.

Samantha Kierath is a freelance writer