

The Bull-Bear Debate

How Quickly Things Change

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“Coal and the Global Energy Market”

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Presenter’s Note

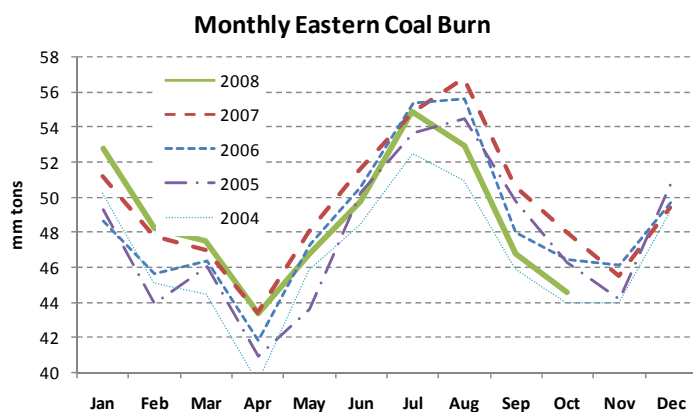
I wanted to take the Bull side of this debate, because the Bear side is too easy. I also did not want to be responsible for any coal company executives going “postal” (or shooting me).

What Has Gone Wrong for 2009?

- The US and world economy is in a severe slump
- Coal-fired generation faces competition from natural gas
- Customer stockpiles are already very high
- Most electric power customers have already purchased all of their needs for 2009
- Steel production has been slashed by 30% - 50%
- Overseas steel customers have not bought coal yet and will buy much less than in 2008
- Coal producers have not closed any mines and won't close until they are forced to by lack of demand

What Happened to Electric Burn?

- In August and Sept. Eastern coal burn was off 6% - 7%, but October was down 12%



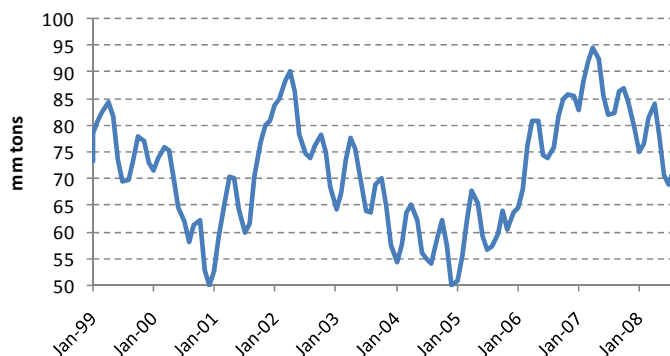
The Causes of the Burn Decline

- Total power sales were down 3% - 5% in the third quarter
 - The weather was very hot in 3Q 2007 and mild in 3Q 2008
 - The economic decline cut industrial demand by 1% - 2%
- Coal lost market share in power generation
 - Coal-fired generation faces competition from natural gas
 - Gas displacement started in August when gas prices fell below \$8.00 per mm Btu
 - Gas generation costs were \$56 per MWh
 - CAPP coal prices were still very high, at over \$6.00 per mm Btu delivered (\$125 mine plus \$25 freight)
 - Coal generation costs were over \$60 per MWh in the SE

The Impact on Customer Stockpiles

- Coal stockpiles are headed toward record highs
 - Eastern stocks fell 10 mm tons in the first 8 months due to the shift to exports
 - The drop was eliminated in 2 months (Sep/Oct)

Eastern US Coal Stocks



Gas Competition is a New Problem

- Gas has never competed with coal before
 - Whenever gas prices fell to equal coal, the burn increase pushed gas prices back up
 - Only happened twice before, in 1992 and 2004
- What has changed this time?
 - The gas glut is large and long-lasting
 - Demand destruction due to industrial plants closing
 - Supply growing with shale plays driven by +\$6.00 prices
 - Delivered coal prices are much higher than before
 - Eastern coal prices are still higher than any time before 2008
 - Rail rates have more than doubled since 2003
 - Excess CCGT capacity is huge, with 7,000 Btu heat rates
- Excess gas supply is 2 bcfd (equal to 50 mm tpy) and may not shut in above \$4.00 per mm Btu

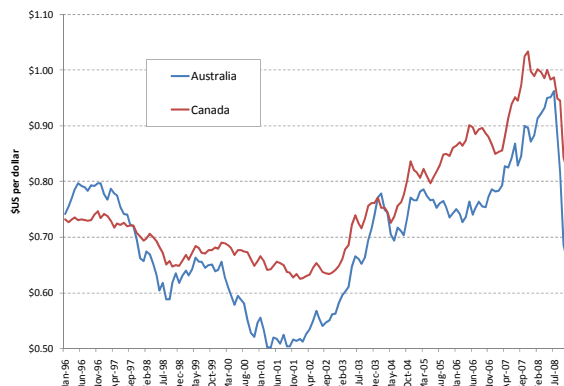
If You Think the Domestic Power Market Is Bad

Coking Coal Will Be A Disaster

The US Dollar Has Jumped in Value

- The financial crisis had the effect of causing investors to buy T-Bills and the US dollar soared
 - The Australian dollar fell to 65 cents from near-parity

Currency Exchange Rates for Met Coal Exporters



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Coking Coal Prices Should Sink

- Australian/US dollar rates directly impact the world price
 - When the \$A was last below 60 cents, JSM prices were \$44 per mt
 - In 2007, the benchmark price was just \$98 US (\$125 Aus at 78 cents per USD); in 2005 it peaked at \$160 Aus (\$125 US at 78 cents)
 - At 65 cents, \$160/ton Aus is just **\$105/ton US**

Exchange Rates and JSM Benchmark Price



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What About Steel Demand?

- Seeing the collapse in car sales and construction, steel companies didn't wait for the axe to fall
 - Steel producers announced immediate production cuts of 30% - 50% to avoid a market glut and support prices
- What will happen to coke and coal demand?
 - They have to fall by 30% - 50% also
- US world market share is likely to decline
 - We are still the high-cost producer in the world market
 - US coking coal exports have to fall by a larger percentage than Australia and Canada

Freight Rates Make the Problems Worse

- World vessel rates fell by 90% from mid-2008 to now
 - China cut iron ore imports as new vessels came into service
- US coal benefits when ocean vessel rates are high
 - Met coal export freight advantage to Europe
 - Higher cost for imported coal
- US rail rates will increase in 2008
 - Rail rates lagged the market in 2008 and will catch up now
- Net mine prices could be frighteningly low
 - US may have to match a \$105/mt benchmark price
 - Freight costs could be \$35 - \$40 for rail and port
 - Net hard coking coal prices would equal \$55 to \$60 per ton

Won't China Bail Us Out?

- China's impact on the world market was not just because of its high demand growth rate, it was the relation between demand and domestic supply
 - Demand growth has averaged 200 mm tpy
 - Production growth has averaged 180 mm tpy
 - Net exports have fallen by 20 mm tpy
- China's demand has slowed but not its supply growth
 - Exports of steam coal and met coke will grow in 2009
 - Cheap Chinese coke could bury the world market
- What caused Chinese economic growth to slow?
 - Was it the end of construction for the Olympics?
 - Was it the drop in exports to the US?
 - Hard to know

Domestic Met Coal Markets

- Domestic steel mills and merchant coke producers have already bought 2009 coal at very high prices
 - Except ArcelorMittal
 - What will they do with the coal?
 - I'm sure coal producers will be just as tolerant of customers failing to perform on contracts as the steel companies were
 - Recent acquisitions of small Appalachian producers by AM and Severstal will be disasters; vertical integration will fail again
 - Merchant coke producers will be squeezed by falling steel demand, cheap Chinese coke imports and high-priced coal contracts

Do Coal Producers Have Discipline Now?

- The steel companies got ahead of the drop in steel demand by cutting production
- Not the coal companies!
 - Name one announcement of closure of a coking coal mine
 - Most coal companies still project production growth for 2009
 - Where will they sell the coal?
- But they sold forward didn't they?

A Coal Miner's Prayer

Dear God:

Please Give Me One More Year Like 2008:
I Promise I Will Sell Long This Time