# It’s time …

First published as a Post on LinkedIn 14 April 2015



## TIME TO GET THE HEAD OUT OF THE SAND.

### Two false pillars of regional economic rejuvenation

Waiting for the ebullient, rollicking, boisterous noughties to return strands us in a fool's paradise. Reluctance to accept loss is a natural phase in our collective grieving for the seemingly bottomless wealth of the pre GFC world.

Fuelled as it was by global financial innovation that resulted in more funds than sense making their way into the property sector, with living standards boosted by a high Aussie dollar on the back of a mining-induced terms of trade bonanza, it's understandable that folk would be longing for a return of better times. Surely, all we need is to once again:

1. rejoice in cranes on our inner city skyline, and
2. bask in the glory of booming coal exports.

These twin hopes lull people into thinking that the answer to North Queensland's funk is a government sponsored capital injection (get those cranes back up!) and somehow, for government to fast track, facilitate or in some way, shape or form, make the Adani Carmichael coal mine a reality.

The prognosis is wrong, because the diagnosis is wrong-headed. Let's take them one at a time.

### More building won't save the CBD (or the economy)

First, the impulse to throw money into construction. No doubt, construction activity has significant direct and multiplier effects. But these tend to be like sugar hits, and if there is no sustainable demand for the new infrastructure (whatever form it takes) then, once the building phase is over, we'll be left with under-utilized assets. In lay terms, these are called White Elephants.

A belief in a capital works induced recovery can also result in unintended negative outcomes. For example, in 2013, on the back of Council rates holidays and State Government leases, two new office towers were constructed in Townsville's CBD. These were bankable because of the quality of the tenancies. The lenders were confident they'd get their money back (with interest!) and the developers were confident in the profit streams that awaited them. Some jobs got created in the process.

Pity that CBD commercial vacancies have hovered between 20-30% for the best part of the past 20 years, and latest figures from the Property Council (October 2014) point to a present vacancy rate of 27%. The new buildings have contributed to a longstanding legacy of over-supply. Not surprisingly, property values in the CBD continue to be no better than half of what they were two decades ago.

The developer big business lobbying outfit Townsville Enterprise still crows about these new buildings as if they represented a viable economic recovery. The refusal of vacancy rates to budge is the real indicator of their myopia.

Capital works projects also have the distinct possibility of crowding out works that would have otherwise been undertaken elsewhere. In other words, they suck resources into them that would have been deployed on other building sites. The net result is a redistribution of activity, rather than a net addition to it.

The CBD's problems are deep-seated and historical. I've touched on these issues in more detail in a previous post, so won't dwell on the issues here. The point to note is that there is a chronic state of over-supply (or in other words long term insufficient demand), and the solutions won't come from boosting supply. What's needed is to drive *sustained demand*, which will only come from a revived *regional* economy.

### In all probability, it's over

The second bit of wishful thinking is that the city's and region's prospects will rebound if only the Galilee Basin coal projects would get opened up, and opened up fast. Again, I've summarized the key issues of the Carmichael Project, which spearheads a trifecta of proposed coal mines in the Galilee, in a previous post. So, I won't go into it again here.

The important developments since the last post that deserve attention are:

1. The Indian Government's pre Christmas public recognition that a "paradigm shift" in Indian energy policy was needed within the next five years, including the conclusion that India cannot afford electricity generated by imported coal, and
2. The Indian Government's recent decision to open up its renewable industry to global capital to drive development and transformation, by underwriting solar power purchase agreements in US$ rather than rupee.

Both these developments were reported in the national press late the week before last. The implications are straightforward: if Carmichael was facing an uphill battle already to be financially viable before, it's now becoming - in the words of the journalist reporting it:

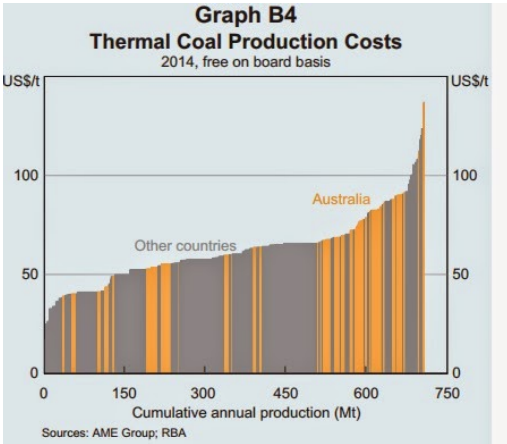
> *even more speculative.*

**It's basic stuff: costs > price = no go**

And yet, Townsville Enterprise continues to hang onto Carmichael as the region's great saviour.

Put aside the recent announcement by three large French banks that they wouldn't fund the project (they weren't asked to, apparently, so let's not get too carried away with this news). The fundamental reality is that unless the Indian Government comes to the party with substantial subsidies, TEL are going to have to figure out how to magic global thermal coal prices up from US$55/t to over US$110+/t.

Just take a look at comparative production costs in the chart below. On an FOB basis, Australian miners are right at the wrong end. Resources that haven't been opened up yet logically sit further up the cost curve. On an FOB basis, my analysis is that on broad terms Galilee projects are sitting at around $85/t FOB on costs.




This was confirmed to me mid-2013 in discussions with a Beijing-based miner with interests in the Galilee who said:

> *Unless prices get back to over $115 a tonne, we won't even bother sending anyone to walk the site. Maybe we'll end up being graziers.*

Current coal prices are, for those who watch these things over the long haul, some 35%+ above the long run average. Unless coal prices recover to sustained levels of US$110+/t, the chances are that Galilee coal ain't going anywhere.

The chart below shows pricing over the last 10 years, and the entire Galilee seems to have been sparked into life by the spike in prices achieved - all too briefly - in mid-2008. This includes Palmer's ironically named "China First" project, which - if it's dependant on Chinese demand - looks like it's hit troubled waters as well.


If India's targeting to unhook itself from energy generated from imported coal, there's also hard evidence that China's use of, and importation of, coal has also declined and will continue to do so. These forces are likely to keep global thermal coal prices depressed for quite some time.

**Never say never, but ...**

I'm disinclined to be the guy who says "never", but given the dynamics in global energy markets and the intersection of finance with concerns about the risks of carbon bubbles, the probability is that Galilee is already a stranded asset.

Galilee coal is stuck in the ground, whether we like it or not, together with the ostrich heads of those craving for a quick, painless end of the post-GST malaise. If the Galilee does take off, it'll be because global coal prices have rocketed past the $110/t mark. Meanwhile, if you're into serious regional development, don't bank on that happening any time soon.

Prudence and evidence-based decision-making demands that these two false premises be abandoned. To do so would be cathartic, and highly recommended.