feature

Coal Trading Market Evolves With the Industry

Short- and Mid-Term Trading in Physical Cargoes Supplements Long-Term Hedging in Financial Markets

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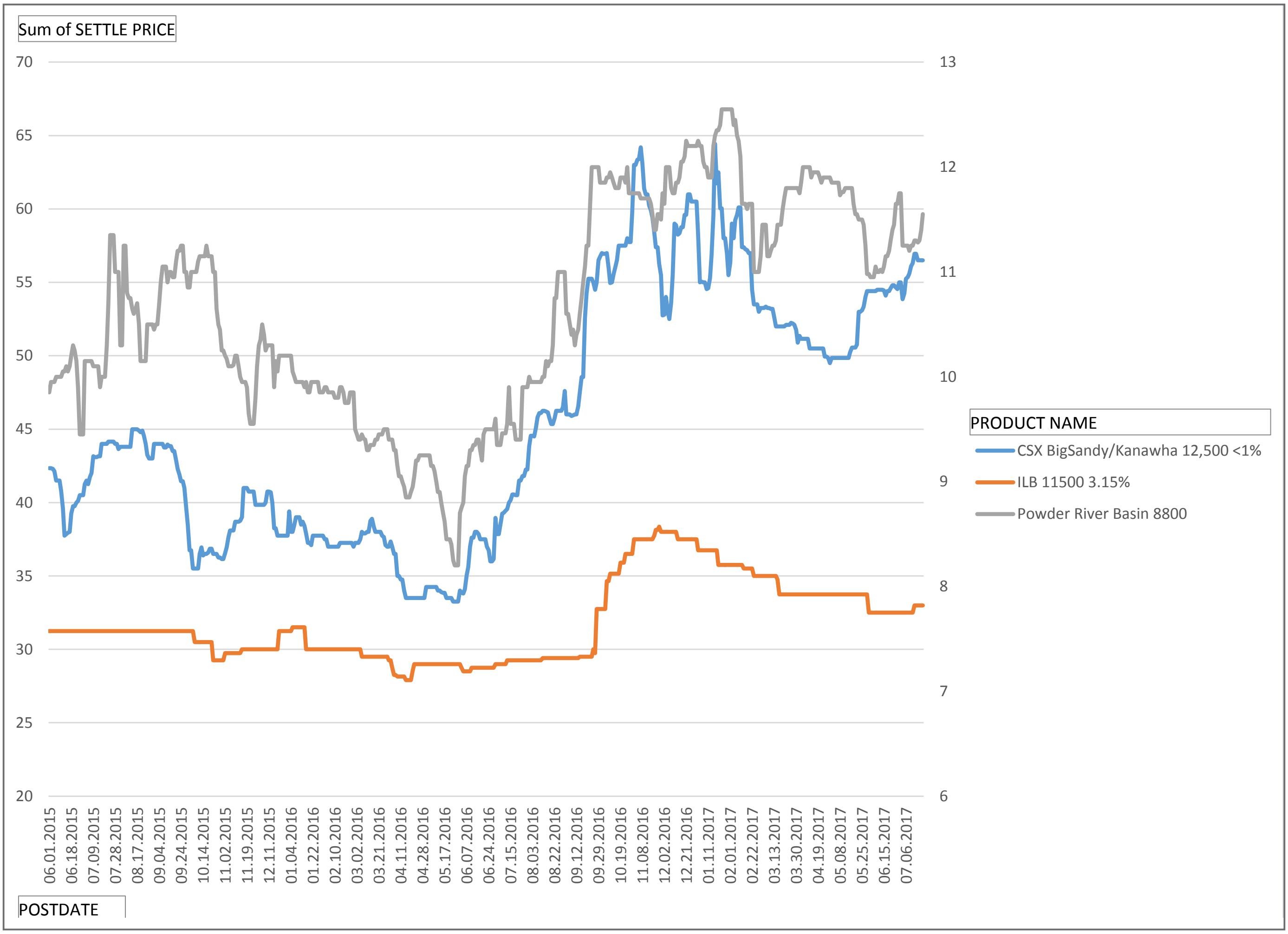
Coal trading markets, as with the rest of the coal industry, are in transition. Producers, power generators, traders and other market participants are increasingly utilizing the over-the-counter (OTC) markets for spot, mid-term and long-term physical transactions – even as they continue to function as a vital hedging tool. The result is increased transparency and transactional efficiencies.

Since 2000, the U.S. steam coal market has been dominated by hedging activity in the financial markets. Traders bought and sold short- and long-term CSX rail, NYMEX barge and Powder River Basin (PRB) financial derivatives cleared on regulated commodity exchanges. While these instruments remain a viable means of managing the price and supply risks inherent in the U.S. coal market, traders, utilities and producers have been finding additional ways to supplement that financial hedging by also trading in the physical OTC markets to address their business needs.

WHY?

The answer lies in the state of the coal industry itself. Market conditions and M&A activity have been change drivers. Producers and utilities alike have streamlined their operations, seeking cost efficiencies. As a result, they have become more flexible and



nimble in their approach to coal trading markets.

The nation's power sector continues to consolidate, creating opportunities for optimization in fuel procurement. There also continues to be an emphasis on coal inventory management within the larger context of managing coal, natural gas and renewable generation resources. Diverse fuel portfolios and variable needs are resulting in shorter term coal contracts.

Producers have also been right-sizing their business by closing unprofitable mines, tightening up their balance sheets and remaining as flexible as possible to take advantage of market opportunities when they arise.

In this opportunistic new market environment, producers' sales departments and coal buyers at power generators are supplementing the formal request-for-proposal (RFP) procurement process with the use of OTC coal markets.

Advantages include time, and time is money. Buyers and sellers can negotiate transactions within hours instead of weeks. These can range from a simple spot train to a multiyear deal, negotiated bilaterally between counterparties. Bilateral trades are subject to successful contract negotiations and buyers and sellers accepting credit, but with the maturity of the market, most trades involve counterparties that already have these terms and others in place.

Much of the physical OTC trading is for shorter term transactions. "Spot month" (one month ahead) or the next quarter (known as the "prompt quarter") are seeing increased activity, and liquidity is strong for these tenors. Traders' interest in longer term trades continues, as overall physical market volume is on the rise.

The emergence of bilateral, physical trading augments the well-established financial trading market. Market participants still use the financial market for short-term and long-term hedging. The financial contracts in the Central Appalachian (CAPP) coal region (CSX Big Sandy/Kanawha 12,500 Btu, less than 1 percent sulfur) and the western Powder River Basin (8,800 Btu, 0.8 lb. sulfur) are still utilized to financially hedge price risk in the U.S. steam coal market. These contracts are financially settled against a respected index, allowing buyers and sellers to protect against disadvantageous price moves. There

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is also a financial options market for both products that traders and other market participants can utilize for hedging purposes.

Unsurprisingly, the most actively traded products are physical steam coal contracts based on standard specifications mirroring financial contracts listed on exchanges. These include the CSX 12,500/less than 1 percent sulfur, the PRB 8,800/0.8 lb. sulfur, and the Illinois Basin 11,800 Btu, 5.0# barge-delivered specification. Other standard physical products that do not mirror a financial counterpart include the NS Kenova Thacker 12,500 Btu, less than 1 percent sulfur, and the PRB 8,400 Btu Joint Line.

The OTC physical trading market is not confined to standard physical contracts. It has evolved into an efficient way to buy and sell off-specification coals from CAPP, Illinois Basin and Northern Appalachia. Coal brokers serving the market are increasingly adept at matching buyers and sellers of off-spec coals, using price benchmarks in the standard products as references, and engaging multiple counterparties to find the appropriate price and meet volume requirements.

Using the market to trade physical products is particularly well suited for the re-emergent export market out of the U.S. Gulf and East Coast. The so-called arbitrage window for coals originating out of the U.S., in which it is cheaper to buy coal from the U.S. and ship to Europe or Asia than to purchase the coal from other locations, can open and close day by day. Brokers have evolved to arrange export cargoes among producers, traders and international utilities, especially over the last nine months.

Producers and utilities alike have streamlined their operations, seeking cost efficiencies. As a result, they have become more flexible and nimble in their approach to coal trading markets.

As the market has transitioned to more physical trading, the role of the broker has been even more important. Brokers recognizing relative buying and selling needs are extending the traditional marketing nexus beyond matching producers to end users. The market routinely sees producers sell to utilities, utilities sell to utilities, utilities sell to producers, and the traditional trading houses participating from both sides to help manage their risk and facilitate transactions.

In addition, brokers have played an important role increasing transparency for standard spec, off-spec and export coals. The trades in the OTC market represent real indications of where buyers and sellers have transacted, giving participants a true sense for the market. This is critical for the new, short-term mindset of the market.

As the market and business conditions for producers and utilities have evolved, the market has adapted to their needs. Trading physical shorter terms works for managing inventories and preserving capital, and the market is well suited to this new environment.

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