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cutting through complexity

A continuing focus on efficiency and productivity

In the Hunter Series – Insights Report

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Since KPMG presented the first *In the Hunter* forum last year, the downturn in the Australian coal industry has continued. More major mining companies have given warning of, or acted on, mine closures, workforce cuts and major asset write-downs. The continual decline in coal prices in US dollars is testing everyone, though the fall in the Australian dollar has cushioned the impact to some extent. The intensity of focus on the balance sheet and financial sustainability now matches the initial attention on the profit and loss. Recent contract negotiations with Japanese customers have further depressed Hunter Valley coal prices and both China and India have announced their commitment to burning less coal in order to reduce emissions, suggesting environmental factors are indeed starting to play a bigger role in shaping future demand – albeit that some uncertainty remains as to whether this will favour Australia's premium 'clean' coal, relative to competitors.

As difficult as the market is, coal is still recognised as an essential and growing energy source that will continue to make a significant contribution to the global energy mix for decades to come. For most Australian miners, the challenge is how they can best ride out the storm, and be best placed to compete in a market that will most likely look quite different to the one that preceded the price crash. The uncertainty of many critical market, economic, political and technological factors is such that the coal sector is going to be one where success comes to organisations who have both strategic foresight and flexibility, built on an obligatory platform of low cost, reliable operation.

A sustainable approach to cost reduction

A sustained low price environment requires a sustainable approach to cost reduction. If this is the 'new normal' for the medium-term then there can be no 'sacred cows'. The thinking and practices that prevailed in the boom, as operations chased volume and were willing to pay to do so, are being scrutinised and challenged. While much of this has been done, many of the short-term measures that were necessary responses have brought their own risks, given the likely shape of the market recovery.

Delivering quick wins is necessary when faced with such a profound shift in a market. However, it can be dangerous to ignore possible longer-term consequences of some of the short-term tactics employed to protect the business. For example, running down stockpiles, deferring prestrip and development, short hauling and deferring maintenance are all logical responses to shaping a more attractive profit and loss when facing a short-term profit or cash challenge. These responses can work particularly well in a short sharp downturn, as a swift return to stronger demand and commodity prices partially offsets the expense of catching up with stripping and reversion to longer haul routes. Given that the downturn is more protracted, a recut life mine plan, based on assumed lower prices, realistic but aggressive cost reduction targets and competitive product specifications, is now required.

Re-negotiating contractors' prices has successfully reduced costs for many miners. While the focus has been on cost reduction, there is much more value to be had by going beyond price, in working constructively and effectively with suppliers. Good procurement teams will work closely with operations to strengthen important productivity and quality delivery from suppliers, often meaning both changes in the mining operations as well as in supplier thinking and processes about how to work with customers. The collective actions taken to reduce supply costs have also led to major risks emerging in the mining services sector. Mining companies need to have a good handle on these risks, and have the flexibility to rapidly address any operational threats that may emerge from the failure of suppliers who deliver critical capabilities.

People are clearly a valuable asset and, in a time of uncertainty, companies need an engaged and productive workforce. Transparency and clear communication are critical in a period of change, especially change that threatens employment and income. Changes need to be carefully managed and the workforce capability and performance risks associated with necessary cost-saving initiatives must be assessed and mitigated. Many operators have been through, or are facing, big shifts in their operating models. This may include ways to more cost effectively deploy capabilities across multiple assets, or shifting some capabilities to suppliers to make costs more variable. These structural changes can unlock important value (and control benefits) but need to be managed carefully to avoid loss of capability and erosion of safety practices. They work best when the workforce is actively engaged and they see the result is a stronger business. KPMG has been trialling new techniques in workforce engagement outside the mining sector that can provide early warning of emerging issues and allow effective tactics to avoid escalation.

Large organisations are looking further ahead by focusing strongly on incorporating the benefits of innovation and new technology in operations. The top tier miners in large-scale iron ore operations have been the most visible in this sense, making major investments, but with substantial scale from which they can deliver returns. The process of extracting commercial gain can sometimes be slow, but innovation is crucial to maintaining sustainable competitive advantage, and the costs of being a fast follower are often lower than being an originator of breakthrough ideas, except where technology exclusivity arrangements exist with suppliers. Now is definitely a good time to scan for innovative practices that can help embed more mature levels of efficiency and reliability in such critical areas as mine planning, bottleneck elimination and process optimisation (especially leveraging broader data availability), maintenance optimisation, and supply management.

Two big cost structure elements that have created a stickier slide down the cost curve are labour costs and access arrangements for infrastructure. As a developed country with high cost of living, and an extended period of wage inflation in the mining sector, we have structurally high labour costs versus our competitors. The 'take or pay' infrastructure access arrangements were critical for access to capital and increasing supply are now a heavy burden and difficult to change. The policy and industry level changes that will deliver better alignment of the export cost structure to the market are not yet clearly emerging, but we expect will be an important part of the restructuring of the Australian coal sector.

Overall, the right portfolio of cost reduction strategies will always be a mix of quick wins and longer-term initiatives, backed with a few structural enablers. Right now, backing up those quick wins with a purposeful portfolio of more fundamental changes to the shape and performance of the operation is critical. Two big things for mining companies to be mindful of now is ensuring they are on the front foot to proactively manage any adverse consequences of their necessarily short-term initial interventions, and they have a plan to start shaping their businesses to compete effectively in the 'new normal' coal market, and the industry scenarios that may play out.

Saving tax at the coal face

Revising tax practices and ensuring compliance should not be seen as a chore, but rather a way of searching out opportunities.

It makes sense for tax functions to align with the mine site optimisation strategies that mining companies are implementing at their operating sites, in the face of falling commodity prices. Coal companies can ensure that tax impacts are effectively managed at site by:

- reviewing existing tax policies and awareness at site
- site visits to monitor tax compliance
- build tax capability at site to actively drive a tax aware culture.

Many cost saving initiatives involve innovation, these can occur right through the mine cycle from project planning to environmental rehabilitation and may, for example, qualify for the research and development (R&D) tax incentive. Any additional projects undertaken by companies should be reviewed to determine their suitability to qualify for the R&D tax incentive.

For income tax purposes, site expenditures are best classified at site to ensure appropriate tax deductions are being claimed, including identifying the ability to deduct any allowable expenditure upfront or alternatively claim deductions over a shorter period of time.

Other areas to consider include fuel tax credits, payroll tax concessions and customs duty. These should be carefully reviewed on a regular basis as part of an ongoing site tax management plan to ensure tax affairs are appropriately managed.

The financial benefits of efficient procurement

As part of a KPMG Global Thought Leadership series, we recently published insights from research conducted with over 500 Chief Procurement Officers[1]. One key finding from the research was that the mining sector lags behind many sectors in terms of maturity in the practices and approaches that lead to the most valuable procurement results. This points to a significant opportunity for miners to extract value by increasing efforts to ensure the impact of procurement in their organisations. Paying serious attention to procurement will be one measure to help bring costs more in line with current coal prices and make it easier to sustain savings and productivity when the market recovers.

A widespread problem is a limited awareness of the value procurement can deliver in an organisation. Procurement is often dismissed as simply 'buying things' rather than seeing the value delivered by clarifying buying needs, rigorous cost/risk analysis, informed sourcing and effective supplier management. Ironically procurement is often excluded from strategic decisions that are predicated on supplier capability. In many cases operations' leadership encourage staff to sidestep the procurement team to deal directly with suppliers, giving little thought to contracts or written agreements, just to 'get the job done fast', a practice particularly prevalent in the boom and exploited by suppliers. If a company's leadership models the behaviour expected, such responses tend to erode the importance of, and adherence to, effective procurement policies, and encourage others to marginalise procurement.

Effective and early engagement of experienced procurement professionals in the sourcing process can help manage the total cost of ownership for materials and services, saving money in price, productivity and support costs. Getting in behind the cost structures of supplier price offers, ensuring specifications properly match need, and developing effective controls to ensure contractor/supplier performance all represent important influences over cost and value delivered.

1 KPMG International Harnessing the Power of Procurement, 2014

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By helping to identify and mitigate supply-related risk (especially given turbulence in the mining services sector), procurement teams can not only reduce costs but also build more operational resilience. For example, managing relationships with a range of suppliers, supporting the capability development of new suppliers to reduce single point risk, and being a critical participant in key insource/outsource decisions can provide more active mitigation of risk.

Effective procurement teams can also be a conduit for innovation. Both local and global providers can be a source of new ideas and technologies, and can become valuable partners in the development process. Procurement teams, with a responsibility to monitor the supply market, are often underutilised in mining companies as a participant in the identification of key innovation inputs, especially if they are principally viewed as merely purchasing administration resources.

Our industry research shows that mining companies on average lag other industries in providing contemporary tools to procurement teams to support their impact and productivity, a reality that we have seen in many operations who struggle to understand supply side opportunities. Many mining organisations have capable Enterprise Resource Planning systems in place, some which include advanced Supplier and Procurement management facilities. Sadly many of these are underutilised, and focused on streamlining processes and administrative efficiency. If IT facilities are evidence of what is important in a function, then this in itself tells an important story.

Some companies don’t have the disciplines to manage a comprehensive and coordinated record of the relationship with a supplier (let alone ensuring consistent messaging to suppliers in operations and procurement interactions) nor the tools to adequately record critical aspects of supplier performance and commercial performance. Thus many are underequipped to have effective supplier review meetings or powerful negotiations. In addition, few procurement teams have ready access to critical market-based information around key price drivers for key categories or commodity groups to inform even the most basic information about price, supply availability and capacity, etc. Improved operating disciplines, with the tools to support them, are an important first step in moving up the maturity curve and extracting more value from what procurement capabilities can offer.

KPMG have helped a number of miners deal with these issues as they came to face-to-face with their own shortcomings. More than a little surprised by how ill-equipped they were to manage the urgent cost out discussions with anything other than a blunt threat of changing supply, some miners had the insight that there was an urgency to strengthen procurement practices and secure more experience to maximise the value delivery from the supply side of the business. The pool of top procurement specialists is small and highly sought after across all sectors. Those who do the best job have a deep knowledge of their industry, and some mining companies are responding to the growing challenge of sourcing the required skills by establishing their own talent development programs and academies. With the market showing prolonged low price characteristics, this is likely to be a judicious investment.

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Global sourcing in perspective

When companies see competitors and suppliers sourcing product from overseas it's easy to assume they should be following suit. This might well make sense, but global sourcing must always be a well-informed choice, equally cognisant of the complexities and risks that go with the often attractive sticker price.

There are many hidden costs and risks in sourcing offshore for materials that have previously been sourced through local partners. For example, logistics and the extended supply chain can result in unacceptably long lead times. Certain stages of the process may disappear from view and global supply chains often have weak links such as under-developed infrastructure and technology. Increased demand could strain shipping capacity and there may be problems with maintaining quality. Purchase of major capital equipment that have attractive unit purchase costs (e.g. rail cars) will typically have the mining operator thinking through the price trade-offs associated with supply risks, parts availability and specification quality, service availability and the risks of contracting in a foreign jurisdiction with quite different laws, precedents and interpretations.

All overseas sources of supply must also be continuously monitored as changes in government, legislation and the various economies can result in significant price fluctuations due to currency movements, taxes, charges etc. Once again this does not prevent offshore sourcing being a wise choice, but the costs and attention required to manage these mattes must be factored in to sourcing decisions.

Many companies admit that they lack the resources and experience to assess foreign supply markets or suppliers. And, critically, the supplier relationships that are often critical to establish a strong service arrangements. Trialling sourcing in some categories/commodities can open the eyes to the general complexities and operating impacts, and can deliver early wins, but it is important to recognise that different categories and suppliers can represent quite different challenges and risks. It takes disciplined analysis for total cost impacts, well balanced decision and risk management criteria, and an objective mindset to properly evaluate the decision to source offshore, especially for critical items. There is much value to be had in pursuing direct off shore supply arrangements, but it takes a rigorous approach to ensure that it is not a gamble.

How can we help you?

KPMG have a range of services focusing on strategy, growth and performance along the mining project life cycle. We deliver across the spectrum of mining client needs – in the pit and preparation plant, in the planning office and control room, in the executive suite and boardroom – or a combination of all.

Our team are ready to be your partner – helping you address your most important business problems. Through our experience across many mining operations, and many ore types, we are well-placed to work with you to understand your unique requirements and formulate outcomes that work for your organisation. Our breadth of experience provides an important and complementary contribution to the expertise and commitment of the organisations we work with. We hope our insights into the *In the Hunter* series and the commentary provided in this publication are testament to our experience and thinking.

Our collaborative approach helps the organisations we work with maintain strong ownership and buy-in to the improvements we assist with, enabling higher levels of sustainability of results. And sustainable outcomes is very much what the coal sector is seeking.

The challenges facing the coal and broader mining industry are complex. It is vital that service providers demonstrate deep technical and commercial understanding of industry issues, and importantly, how to resolve them for each unique client's circumstances.

The mining team at KPMG has this ability, and more. The strength of our capability is our people, who represent market-leading thinking and experience. We are passionate about the industry and working closely with organisations as they respond to their challenges, using experience from a variety of disciplines across our team to deliver better results.

At KPMG, we believe we offer partnering at its best and ask for the opportunity to demonstrate this to you.

Contact us

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