No 28 – October 2015

executive summary

Coal contracts and long-term supplies

Coal contracts can be typically split into two broad categories, spot contracts (single shipments) and term contracts (multiple shipments). Long-term contracts cannot be defined precisely, but can vary in length from anything over a year to a contract that can secure coal supplies lasting more than 20 years. With the exception of minemouth power stations, long-term contracts for coal are less common in the Atlantic market, but garnering increasing interest in the Pacific market. Similarly in the USA, some coal industries are seeing a shift away from long-term contracts to shorter-term business.

Background

In 2014, China's National Development and Reform Commission announced guidelines for coal miners and utilities to agree medium- to long-term contracts; this would steer a move away from the traditional process of annual negotiations and arranging one yearly contracts. The NDRC could instigate a major shift in coal buying in the world's largest coal market. The situation in China is in stark contrast to OECD Europe where hard coal purchases for UK and German utilities are agreed almost entirely on a spot basis.

However, the research found a number of countries and companies operating worldwide that make use of long term contracts to varying degrees. These include: Czech Republic, India, Indonesia, Japan, Korea, Malaysia, South Africa, and USA which are included as case studies.

Supply agreements with minemouth power stations may not require the same level of contractual sophistication due to the short supply chain and will have less detail. For longer distances, an intermediary with expertise in haulage and handling may be included in the contract along with a greater degree of quality checks and auditing to ensure the delivery is prompt and to the prescribed standard.

Regardless of the sophistication of the contract, term agreements offer many advantages that spot purchases do not, especially for power plants operating under baseload. There are numerous benefits and disadvantages to long-term contracts, but probably the primary reasons for adopting such agreements are certainties in the volume of coal of the right quality, and better predictability in the price, whether it is geared to a fixed or a variable formula.

Long-term planning becomes easier, allowing producers (and end users) to plan mine advancements and investments and enhancements in equipment, methods and land planning. It also provides an incentive to explore future blocks of resources when long-term volumes are coupled with long-term prices.

While the agreement secures tonnage over the long term, variations on a monthly or quarterly basis are inevitable. Despite the apparent locked-in nature of a long-term agreement, flexibility in these contracts can be in place to enable the buyer to take more tonnage in some periods and perhaps less in others, all these features being discussed in the report.

Pricing is an essential aspect of any coal contract. Market conditions can alter prices every hour but long term contracts stabilise prices, albeit with varying degrees of fluctuation depending on the price formula. Price agreements are often necessary for a new modern independent power producer. For most term contracts, price

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Each executive summary is based on a detailed study undertaken by IEA Clean Coal Centre, the full report of which is available separately. This particular executive summary is based on the report:

Coal contracts and long-term supplies

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CCC/258, ISBN 978-92-9029-581-5.
90 pp, October 2015?

This report is free to organisations in member countries, £100 to organisations in non-member countries for six months after publication, and free thereafter.

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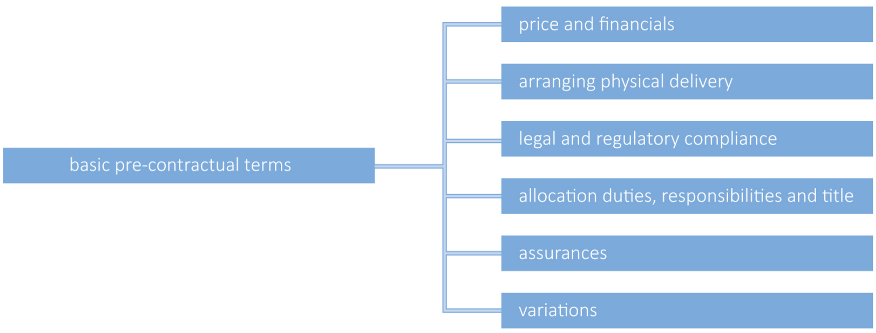
renegotiation can occur annually or every three years, reducing the need to repeat the tendering process, but ensures that both parties are aware of the current market conditions and steers both parties to cost competitiveness.

Long-term agreements can lead to strategic business interests and cooperation to suit both buyer and seller. Both parties can benefit if one owns part or all of the other's assets. Sellers can also enter into strategic long-term contracts with rail and port to ensure a continuity and robust supply chain for many years, offering buyers confidence that the producer has access to sufficient capacity to deliver the coal when needed.

While price, volume and quality are the main criteria for any agreement, a number of assurances must be made by both parties which will fall under the terms and conditions of most contracts. The timeliness of delivery, payment and communication between parties is usually stipulated. Other ancillary services and requirements such as sampling and auditing volumes throughout the supply chain will be common for international shipments.

In summary, under certain circumstances long-term contracts serve as a useful and often indispensable instrument for coal procurement. Flexibility can be built in in terms of volume, price, and quality, while providing greater confidence in the long-term operation of a power plant or group of plants.

This report aims to introduce the reader to the fundamentals of a fuel supply contract, describing the basic structure and approach to purchasing and selling coal, including the various terms and conditions and pricing formulae that can be utilised. The report does not offer purchasing advice, but rather an introduction to analysts, professionals and academics seeking to better understand function and operation of long term contacts.



The basic details of a contract