

## Industry profits surprise government

A A\$30 billion (US\$23 billion) profit surge from an enlarged Australian resources industry was a recent godsend for government budgeting but an ominous sign of future policy-making challenges.

John Robertson\* | 13 Jul 2017 | 9:48 | Opinion



*Australia's treasurer Scott Morrison needs to get a grip on cyclical commodity pricing and budget accordingly*

March quarter data from the Australian Bureau of Statistics (ABS), published at the beginning of June, show the changing nature of the ties between the Australian economy and commodity markets.

The ABS reported resource sector quarterly profits before tax, including those from oil and gas, rose 311% to an annual rate of \$71 billion between the end of September 2016 and the end of March 2017. They accounted for 30% of total Australian corporate profits.

Prior to this recent rise, all the post-2004 industry profit gains that had accompanied the so-called supercycle had disappeared. A \$506 billion capital spending spree had failed to produce a positive financial return.

Lost profitability aside, important macro benefits came with the industry's 10-year investment binge, which accounted for 24% of total private-business spending.

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Every dollar spent on new equipment or structures came with more jobs, higher wages and stronger demand nationwide for goods and services. No part of the Australian economy would have been untouched.

Helped by its exposure to the minerals industry, the Australian economy rode out a succession of macro threats without recession for over two decades.

The ABS data for the March quarter showed a declining, but still elevated, capital spend by the industry in Australia.

Including exploration, industry spending fell to \$40.3 billion over the 12 months to March 2017 from a peak rate of \$94.2 billion in 2012. Despite the fall, capital expenditure remained more than four times higher than the \$9.7 billion in 2002 before the cyclical expansion of the industry got underway.

The spending surge has brought big capacity increases.

Black coal output rose from an average 361 million tonnes in 2002-2004 to 566Mt in 2016. Iron ore output rose by 647Mt. Gas production has risen from 37.2 million cubic feet to 97.3Mcf with a further 40% increase expected.

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Higher production rates now put Australia firmly into the next phase of its resources cycle.

Investment spending might remain well below the frenzied heights of 2012-2014 for decades to come but the country's profit potential has risen dramatically.

The increase in profits during the most recent December-March quarters brought the industry to within just 15% of top-of-the-cycle profits in 2011.

The improvement came overwhelmingly from higher coal and iron ore prices.

According to data released by the Australian government's Department of Industry, coal production was little changed over the year to March 2017 but average metallurgical coal prices more than doubled and lower valued thermal coal prices increased 40%.

The upshot of the coal price movements was a \$6.3 billion surge in quarterly export income, nearly all of which, in the short term, would have fallen to the bottom lines of the exporting companies.

Similarly, a 45% price rise resulted in a \$6.8 billion surge in quarterly iron ore income.

The improved industry profitability, if sustained, would be equivalent to an extra \$55 billion a year.

Unfortunately, the macro impacts of investment spending far outweigh the consequences of an equivalent dollar value of profits.

The most immediate benefit of higher profits is that governments can paper over some of their shortfalls in taxation receipts.

Beyond the fiscal effect, the impact is more thinly stretched.

Some profits will be distributed to shareholders, most of who will reside outside Australia. The balance retained by companies will help sustain investment spending at a higher level than might otherwise be the case but a portion will be retained for a rainy day and contribute to debt reduction.

As well as the evident benefit for cash-strapped governments, the rapid movement in industry profits contains a warning sign.

The resources industry is the most likely source of an exogenous income shock for the Australian economy. Whether Australian income growth is unexpectedly strong or surprisingly weak will depend heavily on global raw material markets.

With the value of the nation's principal mineral commodity exports more than ever a product of short-term macro influences, governments face larger swings in tax collections than they have been used to managing.

Australia increasingly faces conditions similar to those of large oil exporters forced to align their budgets to swings in oil prices.

The Australian government shows no special skill in understanding what drives the key markets on which it is relying for a large part of its revenue base.

A year ago, the government's in-house agency specialising in forecasting commodity price swings had expected coal and iron ore export receipts in 2016/2017 of \$80.7 billion. Once commodity prices started to rise, it upped its forecast. By midway through the year, its forecast was \$47 billion higher.

On 7 July 2017, the agency cut back estimated iron ore export earnings for the just completed financial year by 10% in reaction to the subsequent decline in prices.

At an official level, forecasts have usually been driven by extrapolating what has just happened rather than an understanding of future market conditions.

With the expanded size of the industry and prices increasingly sensitive to small market balance changes, government revenue projections appear more susceptible to error and uncertainty. Multi-year budgeting and implementing debt-reduction plans will become tougher.

Developing countries are constantly urged to manage their fiscal positions so as to avoid spending anticipated commodity market windfalls before they occur. Some have set up independently managed special funds to smooth the impact of commodity revenues.

The Australian government has no such programmes in place and, for all practical purposes, had already spent the unexpectedly improved revenues that came its way in the past year.

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