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HALLGARTEN & COMPANY

Thinkpiece

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FIFO – Divinely Decadent

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Divinely Decadent

- + The FIFO practice that has evolved over the last ten years has lowered the levels of unionized workers in the mining industry in countries like Australia
- + The slowdown in global markets has put the process into reverse
- + Mining companies are now in a better bargaining position because of the slowdown
- + Politicians have recognized the problem and are moving in to attack the practice, effectively taking the policy out of the hands of miners with little commitment to reform
- × Operational costs have rocketed during the boom due to unrestrained demands from FIFO workers, particularly in Australia
- × New mining regions have not created viable communities on a lasting basis due to the lack of a permanent populations
- × Existing mining communities fail to build critical mass due to workers essentially by-passing the goods and services of the local area
- × Infrastructure in health services, retail and residential construction remains atrophied
- × Massive wage distortions have evolved with a class of unskilled and semi-skilled workers being empowered in wage negotiations merely because of perceived mobility

Mining's Own Goal

When considering the highly negative trajectory that FIFO practices have taken in the last decade, one can't help being reminded of the notorious "old Spanish customs" that used to infest the British newspaper industry of Fleet Street for many decades. Such is the seriousness of the distortions that FIFO has produced that it has even become the subject of an inquiry in Australia. And now the results of the inquiry (or rather the inaction with which they have been greeted) has itself become a subject of controversy.

Our thesis in this note is that FIFO has played a large part in undermining the mining boom by creating unsustainable opex. Even where the practice is weaker or does not exist it has had a negative impact by generally changing sentiment, attitudes and cost basis across the global industry. In the case of gold mining the attrition has been slower, but far more deadly. Gold mines in the late 1990s were operating with cash costs of under $300 per ounce, while gold was between $300 and $400 per oz. Now gold is over $1,300 and serious questions about viability and profitability swirl around some of the large producers, let alone proposed new builds.

Meanwhile whole metal sub-groups, most particularly iron ore and large-scale open-cut coal mining have built a dependence upon FIFO that is hard to break.

FIFO – expediency run rampant

FIFO is, of course, Fly In Fly Out, a proliferating way of mining companies either dealing with the difficulty of securing locally based skilled workers OR the companies not wanting to train up locals or build (relatively) permanent mine towns near their production sites. The practice is at its most notorious and egregious in Australia (that is "within" Australia) but is used all over the world, most commonly though by Australian and Canadian mining companies. The vectors can be many with simple ones being Perth to the Pilbara or Toronto to Mali. Less well trammeled paths include mine workers living in exotic locales of their own preference and flying in to even more exotic (or isolated) locations.

The practice has come in for attack from politicians that have realized that it beggars local communities and hampers regional developments. Meanwhile it has only started to attract attention from analysts, consultants and other observers as one of the inflation drivers (and thus margin-shrinkers) in the mining industry. It should be closely looked at by all mining executives because if they wondered what has spoiled the story of the mining super-cycle, then FIFO is definitely on the list of culprits for opex inflation.

Ancient Spanish Practices

Why would we compare practices in the (recently) non-militant Australian mining industry with the egregious activities of UK unions of the 1960s-1980s? Firstly some background for the terms *Spanish Practices* or *old Spanish customs* are United Kingdom expressions that refer to irregular or restrictive practices in workers' interests. Typically, these are arrangements that have been negotiated in the past between employers and unions but then became "set in stone". The problems arose because, in United Kingdom law, a contract of employment consists of both expressed and implied terms. Implied terms can arise through "custom and practice". Historically, alteration of these terms has been by negotiation and collective bargaining (and strikes).

The worst of the practices were on Fleet Street and resulted in almost totally paralysis of the UK print media industry at some times and ensured that the sector also used to operate with minimal profitability or substantial loss. The demise of these practices, ironically enough, came about when an Australian, Rupert Murdoch, broke the power of the print unions by secretly building a printing plant and employing non-union labour and then in the space of one weekend moving all his UK titles from under the control of the old workers at old sites to new workers at new sites. Game over.

Unfortunately the FIFO phenomenon has had less to do with head-to-head battles with dyed in the wool union leaders and more to do with sloppy management in the mining industry grasping for quick fixes and unable or unwilling to look for cost-effective solutions to capex issues. With gold and iron ore (in particular) running far ahead of cash production costs, the managements had a lot of latitude to "let it all hang out" and went with whatever was expedient at the time.

The Effects

The result of these practices by miners (primarily large miners that set the bar high and thus forced lower miners to scramble to match) was that inflation in capex and opex went rocketing leaving projects vulnerable to margin collapse when the gold price retreated (as it has done over the last year). The traditional practice of building a mining camp with a range of services OR building up a local town into a more "full-service" community went out the window and the quick and expedient solution was to build motel-like facilities and just fly the workers in from a major metropolis or distant town/city. The workers would then appear at site for maybe seven days on and seven days off and then fly back to their homes. This sounds like an efficient saving on town building but it brought all sorts of negative effects for development in the regions where the mines were (essentially depriving the local communities of economies of scale in schools, leisure and retail services) while creating a metropolitan class of mining mercenaries. At the risk of insulting truck drivers amongst our investor base, we would note an individual of our distant acquaintance in Melbourne who was essentially an unskilled worker who managed to get himself an enormously well-paying gig where he could have his cake and eat it too: living in Melbourne and yet being flown regularly out to the far north of Western Australia for a very large wage and just driving road trains of ore from the mine to the port.

So how much was this examplar paid? The newspaper "The Australian" in February of 2011 published a story in which it noted that a laborer (i.e. essentially an unskilled worker) securing a job at one of RTZ's various Pilbara operations would be paid more than $100,000, plus superannuation (pension contributions). It then said one should add another $20,000 or so for an entry-level truck driver without mining experience, while a mobile equipment operator will get at least $140,000 a year. If you are looking after general maintenance, a tradesman (such as an electrician or welder), one would earn $120,000 to $160,000 and upwards, while a supervisor or foreman can earn anything between $135,000 and $230,000. Train drivers are paid $200,000 or more, and experienced managers get $250,000-plus and normally have performance bonuses built into their salary packages.

It went on to note that most RTZ employees work what is known as a "seven-seven-seven" roster -- seven days on, seven nights on, then seven days off. All meals are paid for, as are their air-conditioned units, but four out of five workers are away from home for two weeks out of three and "despite the good salaries there is a high staff turnover as workers, many based in Perth, weigh up the pros and cons on their jobs". Our reading of that last statement is not that they are pondering driving a delivery fan for $40K per annum but rather they are shopping themselves to other miner/suckers and bidding up the price to a (then) price insensitive buyer.

Non-Unionised – A two edged sword

When one thinks about it though the mining industry may have made itself a rod for its own back in eschewing unionized workers. At least with collective bargaining there comes some form of standardization of pay rates. The marketplace of free agents descended into a chaos of upward bidding that created a scenario like a Sotheby's auction for Picasso's "blue period". Any price that would clear the market for truck drivers and various other underlings, was acceptable to the mining companies where price was no object.

The article in The Australian noted that the consensus seems to be that less than 15% of the workforce of RTZ at that time was unionised. About a third of Rio's 300 train drivers are members of the CFMEU. Interestingly other Pilbara workers, who were not employed in the mining or construction sectors, were paid far less.

The resistance of the mining companies in Australia to unionizing their workforces meant that they preferred a non-mining skill-pool (drivers, tradesmen etc) when they could get away with it, but these people didn't tend to live near the mines. In fact it was preferable if they didn't live near the mines as then they would not tend to coalesce into a syndicalist *lumpenproletariat* (there's a word you don't see much in mining research!).

All this created an interesting scenario where the better paid workers were not even merged into the local community and were instead spending their dollars pumping up the already inflated property prices of Perth and Melbourne. So much for trickle down…

The FIFO Inquiry

It is interesting to note that the inquiry report's sub-tile was "Cancer of the bush or salvation for our cities? - Fly-in, fly-out and drive-in, drive-out workforce practices in Regional Australia". We somehow doubt that Australia's burgeoning metropolises were in any danger from this practice though…

Concern about FIFO's evolution in Australia was understandably most prominent in the two states with the biggest FIFO populations which are Western Australia and Queensland, though pointedly no-one seems to know, least of all the Australian Bureau of Statistics, how many FIFO workers there are. One of the gripes in Queensland in particular was that past mining surges have left a legacy of outback towns and that the current boom was scarcely leaving any footprints and just exacerbating the age-old problem of over-sized metropolitan areas and under-resourced isolated rural and mining communities. The FIFO phenomenon was a new twist on this. The push culminated in the commissioning of a report.

The findings of the 209-page report were tabled in the Australian Parliament in early 2012, making 21 recommendation to government including better resourcing communities under pressure from large FIFO workforces, removing tax benefits for companies using transient workforces, a study into the impact on communities and the development of a housing strategy.

Key recommendations:

- Review of funding allocations for FIFO communities so that funding is based on both residents and service populations.
- Provide funding for the Australian Bureau of Statistics to develop a method to measure the extent of FIFO practices in the resources sector and the service populations of mining communities.
- Fund comprehensive research to determine the economic impact on the demand for and consumption of local government services and infrastructure from FIFO workforces.
- Commission a study of the impact of non-resident workers in regional resource towns on the provision of medical services and as a result of this study develop a health policy response that supports the sustainability of regional medical services.
- Identify areas where local governments affected by FIFO would benefit from skills training programs to meet the needs of councillors and senior staff in local government.
- Have the National Housing Supply Council to urgently develop and implement a strategy to address the supply of affordable housing in resource communities and report to the House of

Representatives by June 27 on the progress of this strategy.

- Commission a comprehensive study into the health effects of FIFO and lifestyle factors and as a result of this research develop a comprehensive health policy response.
- Develop a best practice guide for employers with significant non-resident workforces.
- Commission research on the effect on children and family relationships of having a long-term FIFO parent.
- Commission research into the economic and social impacts of establishing regional centres as fly-in fly-out source communities.
- Review the Fringe Benefits Tax Assessment Act 1986 to limit a range of FIFO incentives.
- Review the Zone Tax Offset arrangements to ensure that they are only claimable by permanent residents of a zone or special area.
- Charge the Productivity Commission with investigating a more appropriate form of governance for remote Australia that is flexible and responsive.
- Establish a dedicated secretariat, within an existing government department and based on the Province of Alberta Oil Sands Sustainable Development Secretariat, with responsibility for consulting with state governments and the resources industry.
- Develop strategies and targets for achieving fair access to health services for people living in regional and remote areas recognising the use of FIFO health services, providing for appropriate funding and infrastructure support.
- Require each Regional Development Australia committee to have a health focus in its strategic plan, specifically focussing on long-term workforce and infrastructure planning and the role that FIFO medical practitioners will play in future service delivery.
- Develop initiatives to encourage the provision of tertiary education providers to resource communities.

Interestingly the whole subject came to our attention when we saw a story that two Queensland MPs were complaining that the government had done nothing about the report despite it having been tabled in Parliament so long ago. The thesis is that the Labor government did not want to grapple with the issue (having previously crossed swords to its regret with the mining industry on the Resource Tax several years back). Some observers claim the opposition Liberal Party will be more pro-active on the report should it enter into government in the upcoming elections.

Looking at the recommendations it is hard to find anything to quibble with. It seems like a number of rorts are also alluded to in the recommendations, namely that the workers are working in an isolated zone but living in cities and yet exploiting Australia’s divided tax zones for those is isolated locations, and meanwhile there is an allusion to the fringe benefits elements in the tax code. Quite clearly the report writers felt some aspects of the current tax encouraged temporary camps and FIFO activity to the detriment of permanent population growth and settlement in mining regions.

The trend in the recommendations is towards housing workers (and developing communities) at site or in the region. Of course if this comes at a cost to the government then clearly the government is going to turn around to the mine owners and ask for participation. Certainly it would be much cheaper for miners to part-fund local facilities (in league with the government) than build bespoke mine site towns which will be tear-downs after 10-15 years when the mine is done. Basically reading through the lines the main issues here are regional development ones.

Global Implications

A story by way of illustration: we, last year, came upon an interesting situation. It was a TSXV listed stock that had acquired an asset in the Balkans owned by an Australian entity. The company's two top executives (Australia-based) were extremely well-paid for a relative micro-cap (but there is nothing new in that Down Under). More interesting though was the country manager. He was also very well paid and a native of the country where the projects were located. The amazing thing though was that the country manager lived in Australia as he seemingly did not want to live in-country. So he would board a plane every three months and go over to the country in question spend a couple of weeks "managing" then heard back Down Under. What he did back in Australia remains a topic of conjecture. Here we have an intersection of FIFO with Canadian mores but without any effect as Canadian watchers of the stock in question never knew that the country manager was AWOL (or FIFO to put it more graciously). There is definitely a cultural difference here and despite this egregious example it would appear that Canadians are not as cross-contaminated as one might expect from these Antipodean practices.

The patchy spread of this bad practice is probably due to three main factors. Firstly there is the geographical "division" of the world that has taken place with the result that Canada has its spheres of influence (such as North and South America), Australia its areas (such as South-East Asia) and London its areas (ex-CIS). There is a lot of cross-over from London of the others' zones but not much intersection of Australians and Canadians on their "patches" (with West Africa being the area of most "competition").

The second factor is probably a taxation issue, as the Australian FIFO practice has clearly evolved with a component of tax distortion as a major factor. Thirdly we would note that the most profitable mines owned by ASX companies tend to be in Australia (the large coal and iron ores mines) and that this has meant that the highest propensity to pay has been for domestic projects. This has in turn meant that foreign projects run by ASX companies have had to compete against domestic projects. At risk of making a sweeping statement, we might note that Canada's major triumphs in mining and its most profitable efforts have been outside Canada. When they have been inside Canada (e.g. Voisey's Bay and the Quebec and Ontario gold distracts) there has been good infrastructure already in place with nearby towns with a pool of workers to supply the mines and a willingly mobile workforce.

Conclusions

If one says that the FIFO practices that have evolved in recent times are decadent then it also goes some way towards explaining the decadence (in the sense of decay) in the global mining industry at the current time. FIFO has been one of the drivers of inflation in operating costs for mining. In seeking a non-unionised and floating workforce the large miners have created a Frankenstein where they are constantly being outbid by their competitors and having to then outbid in turn. The floating workforce have even less reason to stick with one employer as they have never upped sticks from their metropolitan and big town roosts and sent down even semi-permanent roots in the vicinity of the mines they work in. Thus all mines are potentially the same when the itinerant worker stands in front of the departure board at the airport and ponders where he might go next and which company he can pair off against another in a bidding war.

This is not to say that FIFO is entirely a bad thing. When Citadel first told us of their mine in Saudi Arabia we could see reasons why the workforce must be FIFO. Likewise other mines across the Middle East have had to employ the practice (frequently using workers from the UK) to deal with “cultural issues” from having resident families in these locales. The back-blocks of countries like Mali and Burkina Faso are also not suitable for resident foreign families.

Ironically the FIFO issue is being temporarily remediated by the mining industry going into sharp reverse. And it appears that some politicians in Australia have breathed a sigh of relief and shelved the hot potato report. As for the mine owners, the boot is on the other foot at this point. Mines are shedding workers, new mine builds are few and far between, so workers involved in projects are now jostling those that work for producing mines over a diminished pile of breadcrumbs. With the number of workers needed being thousands smaller and an interesting inflection point has been reached where the sellers’ market has become a buyers’ market. Though this seldom stays the same forever.

Clearly though if the mining supercycle has legs and stages a rebound then the problem will not have gone away and shall probably just surge back to life. A deeper problem is displayed here.. the mining industry used to be one with mining projects that lasted decades but in the last decade the approach has been to rip the product out of the ground as fast as possible. Thus the workforce has become populated with mercenaries for hire on ever shorter contracts and arrangements. Whereas, in the past, companies faced down ornery unions, now they are having to deal with floating (and ornery) mercenaries. They have created a rod for their own back..

Important disclosures

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