Q2 2021 Earnings Call

Company Participants

- Eduardo Bartolomeo, Chief Executive Officer
- Luciano Siani Pires, Executive Vice President, Finance and Investor Relations
- Marcello Spinelli, Executive Vice President, Ferrous Minerals
- Mark Travers, Executive Vice President, Base Metals

Other Participants

- Alex Hacking, Analyst
- Amos Fletcher, Analyst
- Andreas Bokkenheuser, Analyst
- Carlos De Alba, Analyst
- Christian Georges, Analyst
- Jason Fairclough, Analyst
- Sylvain Brunet, Analyst
- Tyler Broda, Analyst

Presentation

Operator

Good morning, ladies and gentlemen. Welcome to Vale's Conference Call to discuss the second quarter of 2021 results. At this time, all participants are in a listen-only mode. Later we'll conduct a question-and-answer session and instructions will be given at that time. (Operator Instructions). This conference is being recorded and the recording will be available on the company's website at vale.com at Investors link. This conference call is accompanied by a slide presentation, also available at investors link at the Company's website and its transmitted via internet as well. The broadcasting via internet both the audio and the slides change has a few seconds delay in relation to the audio transmitted via phone.

Before proceeding, let me mention the forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Actual performance could differ materially from that anticipated in any forward looking comments as a result of macroeconomic conditions, market risks and other factors.

With us today are Mr. Eduardo De Salles Bartolomeo, Chief Executive Officer; Mr. Luciano Siani Pires, Executive Vice President, Finance and Investor Relations; Mr. Marcello Spinelli, Executive Vice President, Iron Ores; Mr. Mark Travers, Executive Vice President, Base Metals; Mr. Carlos Medeiros, Executive Vice President, Safety and Operational Excellence;

and Mr. Alexandre D'Ambrosio, Executive Vice President, Legal and Tax. First, Mr. Eduardo Bartolomeo will proceed to the presentation on Vale's second quarter 2021 performance and after that he will be available for questions and answers.

It's now my pleasure to turn the call over to Mr. Eduardo Bartolomeo. Sir, you may now begin.

Eduardo Bartolomeo {BIO 15365202 <GO>}

Okay, thank you. Good morning, everyone. First of all I hope you're all doing well. As we have done since the beginning of the pandemic, we kept our guards up in the second quarter of 2021 with all the safety and prevention procedures for COVID-19. Safety, people and reparation, these words have been our priority to since 2019 and continue to inspire actions. We have made progress in repairing Brumadinho. We are working with the authorities to implement the BRL37.7 billion Integral Reparation Agreement signed in February this year. While the authorities are strucked in the work fronts, Vale continued its actions for social environmental and social economic reparation. In the second quarter of 2021, among other initiatives we launched the social strengthening program in 10 municipalities along the Paraopeba River and we are completing a new pipeline to supply the metropolitan region of Belo Horizonte. This deliver is a major step forward in ensuring water safety for nearly 6 million people.

The reparation of individual damage also continues to advance. Since 2019 more than 10,700 people have entered in civil or labor compensation agreement with Vale, totaling nearly BRL2.7 billion. As you can see we are repairing Brumadinho in a quick, fair and agile way. We have advanced in the safety of our dams as well. In the first semester, we removed the emergence level of four structures and reduced the emergence level of another two. In the upstream dam, decharacterization program, we completed the works of the Fernandinho dam at the Vargem Grande complex. So since 2019, six upstream structures have been eliminated.

We also completed the works of the containment structures downstream of Forquilhas and Grupo dams. Finally we are also advancing with the works for a B3/B4 and Sul Superior dams. Earlier this month, we started activities to remove the tailings with unmanned equipment. In addition our dam management model also continues to improve. We have appointed an Independent Tailing Review Board, the ITRB, to each of our iron ore corridors. This practice is in line with the global industry standards for tailings management, the GISTM. By the way we are in line to adhere to GISTM in due time. So we continue to make progress in the quarter [ph] transformation towards the safer Vale.

We have also made progress on our ESG commitments. This quarter we detailed our strategy to achieve our 33% reduction targets for Scope 1 and 2 emissions with an estimated investment between $4 billion to $6 billion. As I said at the Vale Day, Vale is uniquely positioned to lead the transition to a low-carbon mining. We have a high quality portfolio to support decapitalization. We are a leader in renewable energy with around 90% of our global consumption from clean sources and we operate sustainably protecting 1 million hectares of forest, about 80% of which in the Amazon rainforest. As for our ESG GAAP actual plan, we closed another gap with the establishment of a formal due diligence methodology for human rights. This process assesses and address human rights risks and impacts. It will be implemented across all of our operations and critical projects starting with 14 operations in Brazil in 2021. As you can see we remain firm with our ambition to transform Vale into ESG benchmark.

Well, now talking about the operational performance of our business. Our adjusted EBITDA in the second quarter was all time record at $11.2 billion given the increased sales volume of iron ore and good market conditions. We completed another quarter of increased iron ore production, growing 9 million tons compared to the same period of last year. In the first half we were 60 million tones higher than the first half of the last year. We have reached as well an annual capacity of 335 million tones and we expect operate with an average production of 1 million tons per day in the second half of the year. We remain confident that we will achieve our production guidance for 2021. It's been early, we will give more color on that.

In nickel, our performance was mainly impacted by stoppage of the Sudbury operations in June. We continue to negotiate a collective labor agreement for the next five years. In copper, we recover part of the performance compared to the first quarter by accelerating the implementation of a new safety and maintenance process in Salobo and Sossego towards a stronger second half. Despite of this, our portfolio of nickel projects has made strides to ensure they continue to deliver of quality responsibly sourced material to the market. In June, we had the first production of the from Reid Brook underground mine at the Voisey's Bay Mine Extension project. We also signed an agreement for the Bahodopi in nickel processing facility Indonesia with TISCO and Xinhai and the final investment decision is expected in the -- in the next six months.

Finally in Thompson, Manitoba, we are also evaluating investments to extend the mines activities for 10 years. In relation to our cash strengths, we concluded the acquisition of Mitsui stake in the call and logistics operation in Mozambique. This is an important step for our divestment and the other is the conclusion of the ramp up of the Moatize operations. We expect to reach a run rate of 50 million tons per year in the second half and we continue to seek alternatives for a responsible divestment in that business.

Talking about capital allocation, we provided further evidence of our commitment to return value to our shareholders with the distribution of extraordinary dividends of close to $2.2 billion in June. Summing up March dividends value returned around $6.2 billion to shareholders in the first half of 2021. In September, we will distribute at least another $5.3 billion dollars according to our policy and based on the results of the first half. The final number including extraordinary dividends will be defined as usual in September. And as I said in the last quarter, without compromising the continuity of dividends above the minimum policy, we continued with the share buyback program announced in April. So far the program has disbursed $2.6 billion and is 45% complete. So, discipline in capital allocation is part of (inaudible) and I'm confident that we will deliver on our commitment to maximize returns for our shareholders in the long term.

To conclude, I just want to emphasize that we're still guided by de-risking, reshaping and re-rating value. We have effectively advanced into de-risking. We are repairing Brumadinho fairly and quickly. We are building a culture of safety and operational excellence. We continue to stabilize our operations. Our ESG commitments are fundamental to our strategy and we continue with in a strict capital discipline, focus on the return to our shareholders. In reshaping, we establish a good case with the VNC exit and we are also looking for responsible exit in Mozambique. And the re-rating will happen as we evolve in our deliveries, which bring us closer to our ambition of being a safer company with more stable and reliable operations, increasing our investors' perception of that. To make that happen, we are working very hard and I want to thank our 70,000 employees, our contractors, suppliers and customers for their resilience, high guard and commitment to our culture transformation.

Now, I'll hand over to Spinelli, who will give more details about the performance in iron-ore. Thank you very much.

Marcello Spinelli {BIO 16240257 <GO>}

Thank you, Eduardo. Good afternoon, everyone. Let's start bringing an outlook about the production of this year. We want to reinforce our production guidance, it is a range of between 315 million tons and 335 million tons. We increased as Eduardo said 60 million ton in the first half comparing to last year, 12% of production. If you don't add any more volumes to the second half, you can see that we are in the lower range of the guidance, but what can make us believe that we can deliver more in the second half.

On my right hand side, I have some stuff that I want to share with you. Firstly, we are a dry season now. You know our seasonality, we've been running our operations 1 million tons a day. Second, East range, we anticipated the ramp up of East range. It was -- the previous plan was for third quarter. Now we are in full capacity in this range. Third, despite the limitation to produce more with wet processing Brucutu, our team in a teamwork, we could add additional volumes for high silica there due to the market condition that we have nowadays. Four, (inaudible) that's news from from last week. And here, not only volume, but we can now reduce the risk and have the full capacity. And last, but not the least, we have a very brand new asset now, Maravilhas III, since the last Tuesday is raining [ph]. So again now bring the wet process in full in Vargem Grande and we're waiting for an additional capacity in a couple of weeks with the resume of the conveyor belt -- a long long distance conveyor belt that is over the Vargem Grande dam.

So let's move to next slide. Now I can that can give you an update about the resumption plan. While since the last conference call, we had several achievements. I want to reconcile the numbers here with you. We left last quarter with 327 million tons of capacity. Since then we added with East range plus 2 high-silica Brucutu plus 5, Fabrica full capacity since last week plus 4, Maravilhas III plus 4. The sum is 342, but we need to decrease the capacity that we lost in Itabira. We started this year saying that the capacity of Itabira this year should be minus 9 and after hard work in Itabira, handling the materials we could reduce this impact to minus 2. And as I said in the last conference call with several small delays in other fields, we have a minus 5. So the net number is 335 of capacity today.

Next slide please. So what we expect for the second half. So as I mentioned Vargem Grande, we want to unlock the capacity through the end of this quarter plus 6 million tons. And also on S11D, we have the (inaudible) crusher. We already installed one, we have another -- the second one this year and we have the other two for next year. And about Brucutu in Torto Dam, we announced in our production before that we are -- we have now another start up for Torto, second half of next year. Torto Dam is under construction is going well, but we decided to have some extra work to guarantee all the safety standard for that dam. I want to remind you that we need some extra time to have the final permit from Maravilhas III that already had the permit. So that's our new forecast. Again for that site in Brucutu, we also have more two initiatives to recover capacity. We have the filtration that is under construction and also (inaudible) dam that we're not using today, but we have a plan to bring back next year. So despite this delay in Torto, we partially offset the capacity of Torto, bringing more 5 million tons with high-silica in Brucutu also 5 million ton in Itabira as I mentioned that we reduce the problem since the beginning of the year.

To conclude, in our roadmap 400 million ton, it's important to say that we are also with projects online. We have the filtration in Itabira, Brucutu. In the North, we have Gelado plus 10, the 100 million tons expect to add capacity in the end of 2022. Now, I hand over to Luciano Siani.

Luciano Siani Pires {BIO 15951848 <GO>}

Thank you, Marcelo. A few remarks on each of the businesses. As you saw the performance of costs, there was an important increase on costs before third party purchases towards BRL17.8 per ton. We're now expecting to end the year between BRL16 to BRL16.5. There were one-offs in this quarter, most importantly demurrage costs increased a lot because of the repairs in the ship loader in the North and the queue of vessels increased. However, we are now feeling some inflationary pressures. Diesel costs have increased a lot. Mining parts, we're starting to see some service inflation, but still with the dilution of fixed costs we expect this decline over the next quarters.

Reminder that Q3 will still be impacted by the carryover of the production, higher cost production from Q2 through inventories, but in Q4, you should see the full at least BRL1.5 decline compared to current levels. The opportunities going forward to reduce costs first and foremost is to unwind all the COVID expenditures, if we continue to progress and controlling the pandemic. Today iron ore spends about BRL150 million a year on cost and expenses just on the pandemic measures. On costs alone this is about BRL0.30 per ton. We expect to start unwinding this soon.

We have the normalization of operations Timbopeba, Fabrica those who already reached full capacity should start to post better cost performance in upcoming quarters as well. And finally, we did have an increase in maintenance expenses related to the catch-up that we are doing. We are implementing the VPS, Value Production System model. It requires systematic maintenance to go from the prior levels of 20%, 30% of total maintenance activities towards 70%, 80%. We're getting very close to that. Once we have most of the maintenance being done systematically we should normalize maintenance costs as well.

On the pellet side just call your attention to the substantial increase in realized prices from BRL192 to BRL255, a reminder that is BRL255 includes a mix between CFR sales and FOB sales which the deduct freight rates and also that increase should have been even higher, if it wasn't for the fact that an important fraction of the pellet sales they have its prior quarter prices that command those sales. So therefore the price increases in the second quarter have not yet gone through the pricing systems for pellets.

Actually paid premiums are around BRL60 for blast furnace pellets and BRL70 on top of the 65% for direct reduction pellets. So the premiums increased substantially in the quarter. We are now also selling more of direct reduction pellets which command a higher premium. So that explains that very healthy increase in pellet premiums and also that highlights the opportunity that we have ahead because two of our major operations, Itabira and Brucutu, which are performing well below potential awaiting the filtration works and the tailings dams works. These are the ones who produce pellet feed to supply our pellet plants.

So therefore, once they come back hopefully, we will start to normalize our pellet production and take advantage of this very high premiums. In base metals, I think we missed consensus by maybe 12%, 15% on base metals EBITDA. Perhaps that was because of the assessment that the market made about the impact of the Sudbury strike. Just a reminder Sudbury is a polymetallic producer not only nickel production suffered but also copper production, biproducts production. So Sudbury does have a very large impact on our operations.

Even if we resolve quickly the strike we will still have lot of -- many weeks until we normalize and also we have some major maintenance program, the regular 18 months scheduled maintenance is to be done over the next few weeks as well in the surface facilities in Sudbury.

Finally on coal. In June, we started to consolidate the results of the business in the corridor, the logistics corridor as a result, EBITDA for the month of June was minus BRL12 million the significant improvement the prior months in April and May, we were minus BRL60 million, minus BRL50 million every month. So already the benefits for the coal performance are kicking in and therefore with the ramp up and the current pricing environment we do expect to reach positive EBITDA in the second half of this year.

So let's now move straight to Q&A.

Questions And Answers

Operator

Thank you. (Operator Instruction). Our first question comes from Mr. Carlos De Alba with Morgan Stanley.

Q - Carlos De Alba {BIO 15072819 <GO>}

Good afternoon, for you guys in Brazil. Hope you are doing well. So the question I had, first is on money returns to shareholders. What do you see with the potential increase in dividend taxes the combination going forward of dividends and share buybacks? And also if you can provide any color on the caps to future dividends at least in the second half of the year based on their balance sheet accounts, the capital reserve account, and the net profit, or retain earnings accounts? That will be very useful.

And then if I may ask just on (inaudible) Luciano 12 million negative EBITDA in June versus the 50-50 in prior months, does that already reflect the benefit of the removal of the financial board on the brief finance? And the only thing that is then left to capture is the better economics as the ramp up progresses or are there still some part of the product finance benefits or elimination of those costs that should be reflected on top of the improvement to minus 12? Thank you very much.

A - Eduardo Bartolomeo {BIO 15365202 <GO>}

Thank you, Carlos. Let me begin and Luciano address then any of the take from you, okay. I think, as I mentioned in the beginning remarks Carlos, we have been extremely disciplined on the capital allocation right both in buybacks and in the dividend payment. We did an extraordinary March. Of course we signed that we have at least BRL5.3 point to be paid on September. This is at least because we're going to see market conditions, and they also to define what is the level of extraordinary dividends. As the specifics about the tax reform we were questioned that in a lot the previous call, and we answered the following, is that still on the make, by the way is something that should be neutral. That is the plea from both government and legislators that would either increase in -- if there is an how can I say that --factor of taxation or dividends would be a reduction on the above the line. So it would be neutral, but anyhow we won't change our dividend policy, because of that. Because dividend policy and philosophy is to the surplus of maintaining our business health and running is going to go as soon as possible to the shareholders.

So with that, I think there is a specific question about the reserves, and I think Luciano can explore that as well, and give some more color on what I've just explained. Okay. Luciano, and then you go to what is Moatize, please

A - Luciano Siani Pires {BIO 15951848 <GO>}

Okay. So Carlos at current levels of cash flow generation there is no competition between buybacks and an extraordinary dividend. So we've been doing both, and we'll continue to do both. Different, the shareholder base is spread all around the world. So different shareholders, they have different tax regimes. So it is even possible that for some of them that are already taxing their dividends that the current proposal even could -- even be beneficial. We at least hope that it's going to be neutral as Eduardo said for the Brazilian shareholders but for some foreign shareholders could even be beneficial.

So because of this heterogeneity of the shareholder base, we would rather be not take sides here and continue to do both thinking about the because we can do both, and that's clearly appetite for both also in the shareholder base. As regards to the reserves this is going to be a, if any this is going to be a temporary effect because as you see we are building reserves very quickly. And there will naturally come a point for example, perhaps in the first quarter that the cash flows will be less than profits generated. For example because in January, we have to pay the annual income taxes, and it's natural that the free cash flow generated in the first quarter will be well below the profit.

So any -- if there is any restriction, which should be corrected a very quickly. The other thing that we might do is that we did before is to pace the dividends into quarters instead of just doing it in a lumpsum. So we're certainly going to be more than the minimum in September, but there is -- we cannot rule out additional dividends in December as well based on the profits generated in the third quarter.

On Moatize, yes the benefits of the removal of the project's finance have fully kicked in into the minus 12. So now what we have to pursue going forward is the better economics as you mentioned of the ramp-up and higher sales to -- to go into positive territory.

Operator

Our next question comes from Mr. Jason Fairclough with Bank of America.

Q - Jason Fairclough {BIO 5457682 <GO>}

Yeah (inaudible) everybody, good day from London. Just a couple of quick ones from me. First, can we just talk about Samarco. It appears that some of the involved parties want to renegotiate some of the amounts that has already been agreed, so any color you can provide would be really helpful and if there is any implications for the Brumadinho settlement? Secondly, just on your guidance, could we just talk about the guidance to return 400 million tons by the end of '22? I'm trying to understand what benefit you take from guiding from such an aggressive return to nameplate capacity when the market basically is not rewarding for me -- rewarding for it, any thoughts there?

A - Eduardo Bartolomeo {BIO 15365202 <GO>}

I'll go ahead on Samarco and then Spinelli and I can talk about the guidance. Why is so important to come back to the nameplate capacity.

Q - Jason Fairclough {BIO 5457682 <GO>}

Hello.

A - Luciano Siani Pires {BIO 15951848 <GO>}

Okay. I'm sorry, I was in mute. Okay. Just a reminder here to give some part of the history. In Mariana, in 2016 -- in 2016, there was an agreement between the state governments (inaudible) institution in Samarco with support of the shareholders and where 42 programs were defined to ensure full reparation and compensation amounts were also defined. In 2018, there was another agreement in which the public prosecutors joined in and there was a review of the governance of the Renova Foundation, okay to to improve the participation that those affected. And this agreement in 2018 had already a provision that two years after its signing, the party would sit together again to evaluate the effectiveness and the functioning of the programs. So not of the entire agreement of each of the 42 programs.

What Samarco is doing right now is precisely that. It's renegotiating the programs, the 42 programs as provided by the 2018 agreement. It is not negotiated a new agreement for Mariana. In fact many of the programs of the agreement are quite advanced and would make no sense to discard to work already done by the Renova Foundation. So -- and importantly, completely different from Brumadinho where we were building an agreement from scratch, the mediation underway in the Supreme Court right now is aimed at improving execution and governance, respecting the parameters of the valid agreement, which were signed by everyone and the -- the compensation amounts have already been defined in fix.

There are no discussions about values in this mediation because the programs have already been defined, the cost of the programs are provisioned for and the compensation amounts have already been defined and everyone agrees on this. There is a letter of principles which is public that was signed in June at the beginning of the renegotiation progress, which states exactly that. We're reviewing the programs and we're not talking about values, we're not talking about compensation values, which had already been fixed. Now Spinelli on 400 million guidance.

A - Eduardo Bartolomeo {BIO 15365202 <GO>}

Yeah. Yeah, I want to, I think, Jason, has an excellent question, because it's very important to understand why we are focusing on coming back to the nameplate capacity. When you look at the numbers and you drill down on the three systems. The big numbers are coming where from, from Itabira, from Brucutu and from the North. So we are talking about quality here. And then comes to our value over volume, we are not going to put volume on the market as you're right, if you will be not rewarded for that, but at the same time we are functioning and efficiently, operating half of the Brucutu capacity, not in the total capacity of Itabira and having opportunists to increase our operations in the North of Brazil. So we're not saying that we're going to produce 400 million tons, we're going to say that we have conditions to swing capacity to blend in the adequate form. So that's what behind the building up back the capacity and then we use it as we should to in our value over volume, in our commercial strategy. And I think Spinelli can reiterate that, but that's I think a very, very good question, Jason. Thanks for that.

A - Marcello Spinelli {BIO 16240257 <GO>}

Yeah, you were perfect, Eduardo and just to complement, I think in the different mode of operation on both, so safer mode, using dry processing in half the capacity to use, if you need. So that's the available capacity that will be used with our mantra of margin over (inaudible).

Operator

Our next question comes from Mr. Alex Hacking with Citi.

Q - Alex Hacking {BIO 6599419 <GO>}

Yeah. Thank you. Good morning. The first question as Spinelli, just to follow up on the iron-ore capacity, how much -- when I look at figure 12, what assumptions in there are on the Northern system? Because that was always designed with I think 230 million tons of capacity, when we look at production today, it still seems like it's operating below 200 million tons. So what are you assuming on the ramp up there of the Northern System? And then just to follow up on your previous comments. So again, you're talking there about getting through 450 million tons of capacity in the future. I mean, are you saying that you would be willing to build-up to that capacity level, but operate very significantly below that 350 million tons or something like that? And then just one quick question on Moatize, what's the -- what's the mix of met and thermal in that 50 million tons? Thanks.

A - Marcello Spinelli {BIO 16240257 <GO>}

Thank you, Alex for your question. Well, talking about the figures in the North System, yeah, we are designed to deliver the 230 million tons. We still have some construction there, the first 10 S11D and also to deliver the Gelado project. Now we have -- we had the ramp up of S11D. We learned a lot last year to run a non-flexible system or less flexible system, but very interesting in terms of environment and features in terms of cost, but we don't have the same flexibility in an open pit operation. So that is related to the ramp up with adjusting the crushers and it's important to say that we learned this in last quarter, when we have a lot of projects we have to tie-ins. So we can have some impact -- temporary impact when we are adding some new capacity and we learned this and we are going to have in our plan for the near future. And talking about the 450 million tons, again, it is about of pipeline our projects to offset some some setback that we can have. In a mining business you know very well, we can have difficulties like we have now in Torto, related to our construction or a permit, some small delays in six month or even one year. We are in a pipeline to have reliability to deliver all of them. If you don't see the necessity in the future, we don't just don't trigger the project in this pipeline, but we must have the pipeline of 150 to guarantee that we want -- we can have -- we can have the optionality to deliver the 400 million. So that's a idea for 450 million...

A - Eduardo Bartolomeo {BIO 15365202 <GO>}

And Spinelli just to add on you and I think Alex has at the point, 450 million tons is a more medium-term shot and then comes the swing capacity, ability that you just mentioned, okay. That's why we need to build buffers for that and to swing capacity because we have very expensive mines as well, so that's behind and is a medium term. It's not that we're going to use 550 million next year, over next two years or what else even -- even next year for the 400 million. We need to establish our architecture as it was before and then we define as you said, margin over volume as we always do. And Luciano could answer about the Moatize?

A - Luciano Siani Pires {BIO 15951848 <GO>}

It's about 55% met coal, 45% thermal.

Operator

Our next question comes from Mr. Andreas Bokkenheuser with UBS.

Q - Andreas Bokkenheuser {BIO 7182883 <GO>}

Thank you very much. Just a quick question from me on freight. I know we've talked a little bit about this before. We are obviously seeing a bit of freight cost inflation, but over the last few months has obviously been talked about new IMO rules on freight and carbon emissions and so on so forth. Can you just remind us, how does the freight contract reset work for you guys? I mean, I know you have long-term freight contracts and obviously freight rates are right now hovering around $27 to $28 a ton. So I guess the question is if freight stays at this level, should we just expect even your medium to long term freight contracts to be reset at that level or do you have any kind of fixed freight contracts with some of your ship providers? That is my question. Thank you very much.

A - Marcello Spinelli {BIO 16240257 <GO>}

Andreas, it's Spinelli here. Well, two points here to address. The first one is about the market, the spot market today. You're right, it's surprisingly robust in this first half. I can say it's surprising because we can see the small smaller vessels Panamaxes, Handmaxes, they were really under pressure with high demand because of same pattern of the Capesize business, but there were the whole market was really robust in this first half. And we still see this market higher level than we expect. We don't see this a long-term trend considering the supply demand in this market.

The other part, the other question that you made related to IMO regulations. This is an important point. I am always is defining the regulation for some time. They set a goal for 2030 for reduction of 40% of the regions. It was related only to new vessels after 2015. Now we are extending to 16 vessels. What we see in our fleet, we don't have any impact in terms of cost only the first generation of (inaudible) considering maximal speed a reduction of 2%, but it's is very small impact. So we don't see an average any problem in our fleet, but in spot market, we can have. It's only for 2023 and after that we have another regulation that you need to keep the efficiency 2% a year.

In a rank that you will define E2E in terms of efficiency of the vessel. So in this case, if you don't comply on that target you going to have a reduction of your power and you, again this can be something that we must track but at the same time the business will react to this bringing technology. I want to emphasize that we have our projects, our set of projects that is called echo shipping. They brought our ceiling to a new vessel and we're bringing out air bubble lubrication that's another initiative. Both of them can help out a lot in a vessel to reduce the emissions. And we have a set of projects that can make this evolution better and we need to definitely talk to our ship owners to implement these initiatives, but we are really aware about that.

A - Luciano Siani Pires {BIO 15951848 <GO>}

If I may add, Andreas we will never ever converge towards spot rates. More than 80% of our fleet has 30-year contracts which is cost operating cost and a pass-through for fuel. So for example, our second-generation Valemax today are running at rates of BRL14, BRL15 at these bunker prices, at lower prices they can go as low as BRL10, BRL9 per ton and that's it. The reason why we suffer with higher spot rate is because in the second half, we usually use spots to transport the excess production from the second half to the first half, but this is not ever going to flow through the existing contracts for 85% of our fleet.

A - Marcello Spinelli {BIO 16240257 <GO>}

Just to add little information. Our fleet today is 170 ships and we also bring more -- Valemax in 6 new castlemax this year. So we'll be really well protected for this fluctuations.

Operator

Our next question comes from Mr. Amos Fletcher with Barclays.

Q - Amos Fletcher {BIO 4728914 <GO>}

Yeah. Good morning, good afternoon, gentlemen. Thanks for taking my question. First question is just on the Sudbury strike. How long should we assume this takes to get resolved? And then I wanted to also ask about financial leverage. I mean if we look at your pure financial leverage, you're in a net cash position with the business delivering very strong EBITDA prospectively. Could it be possible to take on a bit of modest levels of financial leverage to improve returns to shareholders even more? Thanks very much.

A - Eduardo Bartolomeo {BIO 15365202 <GO>}

Go ahead, Mark.

A - Mark Travers {BIO 16687422 <GO>}

Okay. So Amos we've been back at the table just in discussions with the USW for about 10-11 days now, and those talks continue today. And so that is a good news to the story of the fact is that we're at the table and engage very --in a very heavy manner with the USW to try and resolve this. Discussions are going well. We feel positive. But of course we can't count on anything until it's concluded, but we remain positive that we can hopefully conclude the deal while we're at the table.

A - Luciano Siani Pires {BIO 15951848 <GO>}

And Amos in terms of financial leverage the answer is yes. We intend to increase our leverage. We had this target of BRL10 billion of expanded net debt. We raised it after discussion with the Board of Directors to BRL15 billion. We're going to do this over time and obviously in the short term we're playing catch up, right given the very strong cash flow generation just to stand still where we are. We're having to distribute everything that we generate, as we promised before and -- but in order to deleverage yes will need to distribute more than the free cash flow and we will do so in the next few quarters.

Operator

Our next question comes from Mr. Tyler Broda with RBC.

Q - Tyler Broda {BIO 16281303 <GO>}

All right, thank you. I guess I just had a question on the third-party volumes. So you had quite a jump in the second quarter about 2 million tons. It didn't sounds like much, but obviously has a big impact on your costs. Could you just run through where those volumes come from? And sort of where we should be looking at for those going forward? Thank you.

A - Marcello Spinelli {BIO 16240257 <GO>}

Thank you, Tyler. Spinelli here. We see the purchase of third parties as an opportunity. We, for this depends on the impact, depends on the index. But you can make money and we do it. In this -- what happened in the second quarter that in the first half actually we have spare capacity in our systems until the rainy season, and the lower production in mine. So we could improve, increase our purchase in and take a advantage on that. Second half, I see that it's more related to what we do. Usually you can compared to the last year. We are full in our operations. Now with (inaudible) and also we have the marketing financial operations we don't see so much increase in this purchase comparing to last year. So that will be stable profit

Operator

Our next question comes from Mr. Christian Georges with Societe Generale.

Q - Christian Georges {BIO 1557701 <GO>}

Thank you very much. Just quickly on what you were saying about freight costs. I think you were saying that you're not seeing the current surge as being sustainable in the long term. I mean what's your take on it? What's your idea of when we should see this current relative cost reverse? And then you said because of more capacity coming to market or more because you're seeing less activity on the shipping?

A - Luciano Siani Pires {BIO 15951848 <GO>}

Thank you, Christian. Well, I think we have a balanced market in Capesize business. We don't -- effect of commodities like soybeans is more related to small vessels not Capesizes. This year they had a -- sometimes use the Capesize for the business, but not the usual use of the Capesize. So that's our view. This market with our even with our return for the market, you see some markets like India or CIA are using Capesize to feed China, they will go back to their domestic markets. Although a balance -- rebalanced in this is something coming from Brazil but reducing for other parts of the world. So that's our view about this, the Capesize market not but again, it depends, other -- on other points, like the other part of the total market in other kinds of vessels, but our trend is not to sustain long term this level of spot rate.

Operator

Our next question comes from Mr. Sylvain Brunet with BNP.

Q - Sylvain Brunet {BIO 3194710 <GO>}

Hi, gentlemen. Two questions from me please. First on iron ore sequential cost increases. Maybe Luciano as you into that some spillover effects, what should we expect into Q3? I guess towards the later part of the year, but what about freight and fuel cost lag effects we should expect in Q3? My second question is on your nickel business context where NTI production keeps creeping, and it is now over 50% of global production. If you take China and Indonesia together does that concern you? And would you consider streamlining your portfolio to favor Class 1 exposure? And maybe I know streamline the non-class one exporter. Thanks.

A - Luciano Siani Pires {BIO 15951848 <GO>}

Okay. So on iron ore costs. So we guided for BRL1.5 million reduction on C1 until the end of the year. And also as I mentioned Q3 will be a middle point from today, and end of the year because of the effects on inventories that there is a pass-through that takes another one or 2 months in order to unwind the inventory produced at higher costs.

So there is no structural change in the next 6 months. But for eventually if we can unwind COVID quicker due to more progress in the reduction of the number of cases maybe we can have positive surprise here. In terms of freight and fuel for today's spot prices and oil prices the freight should stay pretty much the same, maybe a slight increase, because when we sell more we have to resort more to spot freight, which is going to be definitely the case on the third quarter and fourth quarter. But again this is at the margin, because most of the freight is contracted in our fleet. So you should not expect expect significant changes in this variable for Q3 and Q4, some upward tick, but marginal sure.

A - Mark Travers {BIO 16687422 <GO>}

I'll address the question around NPI production Class 1 pivoting. So clearly the, the supply of NPI coming out of Indonesia is increasing dramatically. Right now what we are seeing is that the demand for nickel is quite strong and in fact we are seeing in the market, I would say more or less in deficit rather than surplus. We also see and expect Chinese NPI production to -- to continue to decrease, although it is fair to say that the NPI production coming out of Indonesia will continue to lead to increased overall supply in the coming years, as well as some strong, but we do also have some very strong demand in the stainless steel industry. There are -- I think it's something that we do need to watch in the future years. But overall, in the coming years, we do expect that it not to be an oversupplied market. And as as you may have seen, Indonesia is looking at potential policy moves to limit further expansion of NPI to protect the sustainability of this operate [ph] in the coming decades.

In Vale base metals, we do -- are in a position to play to all three segments in the nickel industry, a high purity, the stainless as well as the chemical to provide to the EV side. We are clearly focusing quite heavily on the high purity and the playing into the energy transition and electric vehicles in particular our Canadian associate. It's important to note, also, that even our Indonesian operations, although providing a -- a nickel matte, we are re-flowing that through to make a Class 1 product out of our Wales refinery.

As also finally I will note that our Onca Puma ferronickel operation is a very -- is quite a profitable operation and it provides us with a long life and continued flexibility even to convert that matte and sulphur dioxide for use in a Class 1 product. So I think we have lots of options to play the market the way we would like to under our strategy.

Operator

This concludes today's question and answer session. Mr. Eduardo Bartolome at this time you may proceed with your closing statements.

A - Eduardo Bartolomeo {BIO 15365202 <GO>}

Okay, thank you. Well, thank you again for your interest and your questions and interest in our business and results. And as we said in all the quarters, it's a -- it's a -- really a marathon, not a sprint. And this marathon requires discipline and persistence and I think we're being there. We actively with the narrative of the re-risking, reshaping and re-rating we are doing our job in the risk of the company Brumadinho and the safety and operations in the ESG. And of course in the capital discipline that you're seeing that is extremely rigid, reshaping has been done, but of course the re-rating is the final -- is the 42 kilometers is when we are really reliable and safe. And then when we will be rewarded with your confidence again and I think that's the word that we're doing with our team and our 7,000 employees. So thank you again and hope to see you in the next call.