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COMPETING FOR CHINESE OUTBOUND INVESTMENT:
AUSTRALIA VS. THE REST OF THE WORLD

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Last week, Ian Ashby, BHP's Iron Ore President announced BHP's aspirational target of producing 450 million tonnes of iron ore annually, way above BHP's current capacity of 155 million tonnes a year.

BHP had previously said it had planned to increase its Pilbara production from 155 million tonnes to 240 million tonnes by 2016.

Rio Tinto has similarly announced plans for major expansion from 225 million tonnes a year to 350 million tonnes a year by 2015. This has been followed by Fortescue Metals Group's plans to increase its own production from 55 million tonnes a year to 150 million tonnes a year and more.

Australia's iron ore industry continues to lead Australian exports to China, producing enormous wealth for Australia with those iron ore exports to China worth $35 billion in 2010.

However, China's direct participation in Australian iron ore production is still insignificant. BHP, Rio Tinto and FMG have largely restricted Chinese participation in their joint ventures, preferring to retain ownership of production in their own hands.

Both Rio and BHP have done strategic joint ventures with China, although on a very limited basis.

In 2001, Rio Tinto signed its Eastern Ranges joint venture with Baosteel. BHP signed its Wheelarra joint venture with four of China's biggest steel mills in 2003. FMG has a 17% direct equity investment by the Chinese steel mill in Hunan Valin.

Rio had pioneered Chinese investment in Australia and overseas, with its Channar joint venture with China in 1987.

The Channar joint venture is regularly referred to by Chinese and Australian leaders in their addresses on Australia/China relations. Every Chinese leader who has visited Australia in recent years has mentioned the Channar project because of its significance at the start of China's investment in Australia. Two weeks ago at the China Iron and Steel Association Conference in Beijing, the new Australian Ambassador to China Francis Adamson also referred to Channar to recognise its role as China's first Australian project, and indeed China's first overseas resources project.

The former Prime Minister Bob Hawke played a key role in its inception when he reached agreement for this project with the Chinese Premier Zhou Ziyang and made speeches about that his key role in opening up the massive trade and investment with Australia which has followed.

With that precedent, China has since invested in other iron ore joint ventures and direct acquisitions, including, for example, CITIC Pacific's Sino-Iron project, Anshan Steel's Gindalbie project, Sinosteel's Midwest project and Shougang in Mt Gibson .

There are numerous other iron ore projects still being developed across Australia, and, Australian

companies are investing in new iron ore projects around the world, in Africa, Latin America and Asia. However, all these projects are producing either relatively small tonnages or are still yet to enter into production. They all require big investment not only in their mine development and processing facilities, but often to develop rail and port infrastructure.
Outside Australia Rio's Simandou project in Guinea in joint venture with Chinalco and the Sundance project in the Republic of Congo which are subject to a takeover by the Chinese and Hanlong Group are two new projects under development, but which will require massive rail and port infrastructure investment to be successful.

In short, however, there is a considerable disconnect between Australia's massive reliance on iron ore exports to underpin its trade surplus with China and China's very limited ownership in the Australian iron ore industry.

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Apart from iron ore, China is investing in resources projects in steaming coal and metallurgical coal, and base metals, especially copper. This investment extends to cover a very wide range of minerals which are so readily represented in Australia.
Today, I will look at China's demand for security of supply of resources for China's unprecedented industrial expansion, how Australia competes with other destinations for Chinese investment, and the attitudes in China towards Australia as a mining investment destination.
1. China's Demand for Resources Investment: Where is China getting its new materials supply

With its massive trade imbalance especially with the United States, China has accumulated 3.2 trillion US dollars of foreign currency reserves, of which around 1.2 trillion dollars have been invested in US treasury bonds and like.

At the Chinese National People's Progress held in March, China's Commerce Minister Chen Deming encouraged the use of the balance of $2 trillion to be directed towards further investment in resources globally to take advantage of the opportunities to acquire major resources at competitive prices.

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Attached is a chart published in the 2010 Statistical Bulletin of China's Outward Foreign Direct Investment.

This shows the structuring of China's foreign direct investment outflow and stock in 2010. China's outward foreign direct investment in 2010 reached US$68.1 billion, increasing by 21.7% compared with 2009. By the end of 2010, China had established 16,0000 overseas enterprises in 178 countries globally. The total invested stock stood at $217.21 billion, $59.73 billion was in equity investments and the total assets of foreign affiliates exceeded $1.5 trillion.

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Attached is another table showing China's outward foreign investment flows by country and region for 2004-2010.
In 2010, Australia was off the bottom of the chart against the rest of the world.

While to date official figures show that China accounts for just $230 billion of the total global stock of foreign direct investment, in a report commissioned by the Asia Society in the United States by US economists Rosen and Hannemann, they predicted that “the coming decade will bring an unprecedented boom in Chinese capital seeking investment abroad in the US alone”.

They added: “We estimate that that Chinese firms will place $1 to $2 trillion of direct investment around the world over the coming decade.”
While Australia’s share of Chinese foreign direct investment remains relatively small, the position of trade shows a marked difference. China is now Australia’s largest trading partner, as well as our biggest export market and imports source.

In the 12 months to June 2011, bilateral trade with China surpassed $105 billion. China now accounts for 26% of Australia’s merchandise exports.

Iron ore is Australia’s single largest export to China, worth $35 billion in 2010. At the same time, Australia is China’s largest source of imported iron ore.

As Australia’s Ambassador to China acknowledged in Qingdao last month, iron ore has been the cornerstone of Australia/China economic relations.

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The attached table shows the outlook for world iron ore trade for 2009 to 2020. China’s imports of iron ore in 2010 were 620 million tonnes, with the official estimates in China for this to increase to 650 million tonnes this year, 800 million tonnes by 2016 and 922 million tonnes by 2020 underpinned by matching increases in steel production.

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Australia and Brazil are expected to remain the main contributors to global export growth. Australia’s share of Chinese iron ore imports remains around 45% and continues to be the largest single supplier. It is predicted to grow from an estimate 437 million tonnes this year to 751 million tonnes by 2016 and 877 million tonnes by 2020.

China relies heavily on imports because its domestic iron ore is typically of a lower quality relative to imported iron ore and has a high cost of production.

There is considerable speculation as to whether and how much China’s steel industry will continue its rapid expansion in the coming years, and how that will absorb the massive volumes of iron ore to come from new projects, and especially from the new magnetite mines being developed across Australia, Africa and elsewhere.

As a note of caution, the Chinese steel producers are looking to a rebalancing of supply and demand predicted to occur in around 2015, if not before, and this will have a major impact on iron ore pricing in favour of the Chinese buyers.

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Australia is also a leader in the supply of metallurgical and steaming coal to China which constitutes major Australian exports.
A session yesterday on coal provided an excellent analysis of the global metallurgical and steaming coal markets and I will not go into detail again here.
The attached table for metallurgical coal shows Australian exports to China in 2010.

In summary, for metallurgical coal, Australia was by far the largest exporter with 160 million tonnes in 2010. China imported 32 million tonnes, well behind Japan and India.

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The table for thermal coal shows Australian exports in 2010 as 140 million tonnes, well behind Indonesia with 215 million tonnes. China imported 120 million tonnes, the same as Japan followed closely by the EU and South Korea.

Australian coal exports are being constrained by the lack of infrastructure. Australia's main competitors are Indonesia, Mongolia and Mozambique.

China has some of the world's largest coal reserves but logistical problems have meant that China has become a major importer of coal, and especially metallurgical coal from Australia. This has been a quite recent development as previously China had been a net exporter of coal.

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2. AUSTRALIAN Competition with other destinations for Chinese investment

The attached chart contained in the 2009/2010 Foreign Investment Review Board Report shows the mineral exploration and development sector approvals for 2006 to 2010.

Iron ore approvals had the highest value, with copper/gold or oil and gas also significant.

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The FIRB reported that in 2010 China was the third largest investor in Australia, after the US and the UK, with a total proposed investment of $16.3 billion.

The majority of the proposed investment was in the minerals exploration and development sectors, accounting for $12.2 billion and represents 75% of China's proposed investment in Australia that year.

The Foreign Investment Review Board has approved a total of $65 billion of Chinese investment in recent years. However, some reports suggest that less than a third of those approved Australian projects will ever come to fruition.

As part of China's "Go Global" policy, China is also investing in new mines and infrastructure in Africa, Asia and South America, leading to increase competition for market share with China.

Africa, in particular, represents a major competitor to Australia for Chinese foreign direct investment. China has been courting Africa for many years.

In 2006 China brought together the largest number ever of African leaders in China in a summit held outside the continent called the "Year of Africa".

The Beijing Summit brought together the leaders of 48 African countries to China. I was in Beijing at the time and the African presence brought Beijing to a halt as the African leaders were ferried around Beijing. China is now comprehensively engaged in almost all of Africa's 54 countries –

lending money, providing aid, trading, building infrastructure and extracting resources.

The rapid growth in China's natural resources investment in Africa has contributed to a windfall of trade between China and Africa as a major supplier of raw materials.

As reported in the China Analyst published by a Beijing based advisory group, bilateral trade in 2010 exceeded $125 billion, considerably more than the Australia/China bilateral trade of $105 billion for that year.

In 2009, China's foreign direct investment stock in Africa reached $9.3 billion.

Chinese investment in Africa is directed to exploration and extraction as well as downstream activities such as processing. China's construction groups are very active across Africa.

A feature of China's investment in Africa is the strong role played by government to government interaction.

One advantage China has had in Africa over Australia has been the exports of significant numbers of labour force to Africa, something often sought from time to time by Chinese construction groups for Australia, but which has never been seen as a possibility for Australia.

At a recent conference in Perth on African investment, around 250 Australian mining companies were identified as being involved in Africa. Many are looking for Chinese co-investment or takeovers, as well as accessing Chinese construction companies to assist with their infrastructure requirements and financing.

Other countries and regions are also providing significant competition and alternative sources for China's trade and investment in resources – Indonesia, Mozambique and Mongolia for coal, Brazil for iron ore and Chile for copper to list just a few.
China's investment is being spread across numerous other countries. Australia certainly has no monopoly on China's resource investment, nor does it always have the best resources.
Australia leads in iron ore, but otherwise the competition is fierce as other countries seek the benefits of Chinese investment.

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3. Exploring attitudes in China to Australia as a mining investment destination

Last month, the WA Premier Colin Barnett signed a Trade and Investment Agreement with the National Development and Reform Commission in China.

At the time, he claimed that China was forging closer links with WA because it was "offended" by the Australian Government's policies, including the mining tax, the carbon tax and foreign investment restrictions.

All three issues get a mention in China today when the Chinese talk about making investments in the Australian mining industry.

Considerable confusion exists as to the impact which the two new taxes will make on their investments.

However, the most significant issue remains Australian's foreign investment regime and how it impacts on Chinese investment here.

A little over a month ago, an iron ore joint venture where I represented the leading Chinese steel producer was finally terminated after waiting for more than two years after documentation was executed to obtain Australian government approval to proceed.

The problem here was its location in the Woomera Prohibited Area and the Australian defence concerns which had previously blocked Minmetal's acquisition of the Prominent Hill project from Oz Minerals.

The same Chinese steel producer was blocked for almost one year when it sought FIRB approval for another project. In 2009, it was required to resubmit five times before its major joint venture equity was finally approved.

During that year, the Chinese did eight other projects around the world to meet the pressure of securing long term supplies of iron ore for its major Chinese steel mills.

Shortly after the Rudd government first came into office, the Treasurer Wayne Swan issued new policy guidelines specifically aimed at China's government-owned enterprises looking to invest in Australia.

China's major investment in Rio Tinto through Chinalco was delayed by the FIRB without resolution until it was finally cancelled by Rio Tinto which refinanced itself elsewhere.

This has been one of the two most cited examples on problems with Australian investment by Chinese officials even though Chinalco created its own problems when it acquired its initial 9% in the dual-listed Rio Tinto Limited in Australia without first obtaining FIRB approval at the time.

The other is the Oakajee Port and Rail Project in WA, which is essential to providing rail and port infrastructure for a number of Chinese owned or invested mining projects in the Mid-West region of Western Australia.

This project was awarded by the Carpenter Government in Western Australia to the Japanese/Australia syndicate of Mitsubishi and Murchison Metals over a Chinese-backed competitor.

Premier Barnett has since made public statements recently that he wants to see Chinese investment brought into the project for it to be successful.

When the Chinese President Hu Jingtao visited Perth in September 2007, the Chinese had understood this project was to be awarded to the Chinese backed syndicate and this was a huge loss of face when this did not happen.

There have been many other hiccups along the way. In 2009, Patrick Colmer, when head of the FIRB, announced a policy at a Sydney mining conference which was to limit investment to 15% in established mines and 50% in greenfields projects, although nothing was ever published by the FIRB to clarify or confirm those announced rules.

Furthermore, there are still no clear and transparent published guidelines available from the FIRB and decisions continue to be made on a case by case basis.

Earlier this year, Patrick Colmer was quoted in Wikileaks as advising the US Ambassador to Australia that the Australian government was discriminating against Chinese investment in Australia. Shortly thereafter, Mr Colmer left the FIRB.

With the passage of time, the FIRB has accommodated a variety of Chinese investment projects, even approving takeovers of operating mines.

The approval process seems to be working much more satisfactorily. However, the legacy of the previous times seems to still prevail at least in some quarters in China.

Nevertheless, the Chinese concerns persist. A report last week in the Melbourne Age by John Garnaut cited Zhang Zhijun, China's top Foreign Mining official, at the recent Annual Bilateral Strategic Dialogue in Canberra expressing frustration with how difficult it was for Chinese companies to invest in Australia.

The article reported one Chinese official to say that "It's just a general sense that investing in Australia can take so long and be so hard."

Here it is important to note that under the Australian Foreign Investment Policy guidelines published by the FIRB any mining investment, at any level whatsoever, by Chinese State-Owned Enterprises must first obtain Australian Government approval.

Investment by private Chinese companies is treated equally with all other investment, but any Chinese Government interest in those companies will override that exemption.

Other frustrations exist in China, Australia's environmental restrictions, native title issues and restrictions on the importation of Chinese labour which does not apply to our competitor countries such as in Africa.

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Conclusion

Australia's relations with China regarding trade and investment are part of the bigger picture of Australia-China political relationships.

China's leaders continue to visit Australia with regularity. Australia responds not only at the Australian government level, but also the various State governments are doing whatever they can to further business opportunities with China.

Despite the competition from other investment destinations, Australia still remains one of the top preferred destinations for Chinese foreign direct investment in resources.

Trade has proved to be far more important than investment, but there are many Chinese invested resources projects which are still in the process of being developed and which will produce major exports in the future.

However, Chinese investment will not be guaranteed. Chinese government has recognised that it has made many mistakes in the past. China's State-owned enterprises has sometimes paid too much and their selection of Australian projects for investment often left something to be desired.

In response, the regulatory processes in China, and especially the enhanced role of the National Development and Reform Commission, have subjected Chinese investment approvals to greater restrictions before projects will be approved in the future.

With the current global financial turmoil, there will be many stranded mining projects in Australia which will be seeking Chinese capital and offtake markets to survive. A Chinese connection may be the only way if they are to succeed.

Western banks have stopped lending for many projects. Many companies no longer have access to the markets to raise additional capital. Chinese banks have the available capital but will be very discriminating as to when and how they will become involved.

Rather than with joint ventures, Chinese State-owned enterprises and private corporations are responding to these investment opportunities by direct acquisitions to give them greater control of projects.

How well Australia does in all of this is the challenge for Australia.

Thank you

R H CHAMBERS