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TRADE AND INVESTMENT LINKS WITH CHINA

MR ROBIN CHAMBERS, SENIOR PARTNER
CHAMBERS & COMPANY INTERNATIONAL LAWYERS

During China's National People's Congress held over the last two weeks in Beijing, the Chinese Minister of Commerce, Chen Deming announced China's intentions to utilise more of its massive 2.8 trillion dollars of foreign currency reserves to accelerate China's push for outbound investment, especially in the resources industry.

China is currently investing more than 1.2 trillion dollars in US Treasury Bonds, which leaves a balance of more than 1.6 trillion dollars.

China is already making numerous investments around the globe to secure long term supplies of strategically important minerals, as well as oil and gas. For all the projects where we are advising the Chinese side, the Chinese are providing the finance. The funds are coming from the central government coffers through China's biggest banks.

While Australia has long been regarded as the preferred destination for Chinese investment in resources, the reality is that, in the face of recent confusion over the Australian Government's policy regarding Chinese investment, China has been directing investment into other areas, most particularly Africa, but also into Latin America and Central Asia.

In 2009, we acted for Wuhan Iron and Steel Group, one of China's largest steel mills. Its application for FIRB approval to acquire a 60% equity in a greenfields iron ore project was blocked 5 times before we succeeded in gaining FIRB approval. Over the 9 month period while we waited for FIRB approval, WISCO did other projects in Africa, Canada and Brazil.

Australia should not misunderstand that the Chinese Government's "go global" policy to secure overseas investments for its resources will continue with investments being made elsewhere if the Australian Government's policy blocks that happening in Australia.

Trade Relations With China

The statistics for trade and investment with China continue to exceed all expectations.

China is Australia's largest two way trading partner, replacing Japan for the first time in 2010.

China also became Australia's largest export market.

In 2009, the value of trade between China and Australia exceeded 85 billion dollars. According to the latest figures, in 2010 two way trade between China and Australia exceeded 100 billion dollars, while retaining a balance in the two way trade flow of goods and services. This represents an increase of around 20 billion dollars in each of the last three years. By comparison, in 2000, total trade was only 14 billion dollars.

This just goes to highlight the serious reliance we have on our China relations.

Resource commodities, especially iron, ore and coal, make up 40% of Australia's exports. Historically, iron ore exports have been number one, but in the past three years coal's export traffic has increased exponentially, even though China has one of the largest coal reserves in the world.

Iron ore exports from Australia are dominated by Rio Tinto and BHP, with Andrew Forrest's Fortescue Metals Group becoming the "third force" that Andrew promised.

In 2010, Rio produced 224 million tonnes and BHP 136 million tonnes. FMG's production was around 50 million tonnes.

Based on the latest available DFAT figures for 2009/10, of this production 72.4% was exported to China worth 25 billion dollars.

Vale in Brazil is the other major exporter of iron ore to China.

Rio has announced plans to expand its production to 330 million tonnes a year. BHP has announced plans to exceed 250 million tonnes and FMG to increase to 100 million tonnes, although Andrew Forrest also talks about expanding up to 250 million tonnes.

We should enjoy these golden years.

Many are predicting that by 2015, or even earlier, iron or demand and supply will reach a balance, based on the massive expansion of new projects not only in Australia, but also especially in Africa and South America.

Iron ore export earnings are enhanced by the pricing policy achieved by the three big producers. Led by Japan, iron ore pricing for many decades after World War II was based on annual contract or bench mark pricing. Prices were fixed by negotiation each year to apply for the whole of the next 12 month period. Many in the industry regarded this as commercially fair, evening out the peaks and troughs over a period of time. It also provided predictability and certainty in planning for both the iron ore producers and the steel mills.

However, BHP had long been pressing for price indexing, based on shorter periods of the calendar quarter, or even monthly or spot pricing. In 2009, the Chinese Iron and Steel Association, a Government body regulating the Chinese steel industry, took over the annual negotiations for the bench mark pricing and rejected the offers from BHP and RIO, while demanding lower annual price increases. The upshot was to end the bench mark pricing system as no benchmark prices were agreed with the Chinese. As a result, the iron ore prices being paid by the Chinese have more than doubled to track the spot prices which had reached heights of even $200 per tonne. The CEO of China's largest iron ore trader, a friend, called the China Iron and Steel Association officials "idiots" for the way they trashed the historical pricing system.

CISA has recently been restructured with a major change of personnel.

To put this into a real context, Rio Tinto's recent profit announcement of around 14 billion dollars represents more than the total profits last year of all the Chinese steel mills combined – which have a total production of 625 million tonnes of steel – which is around half the world's total.

Chinese Investment in Australian Projects

Chinese investment in Australia represents around 1% of the total foreign investment. However, it is certainly expanding, especially in the coal and gas industries. For iron ore, Rio Tinto and BHP, and more recently FMG, have locked up much of Australia's iron ore country. One of the greatest challenges in acting for the Chinese steel mills is to try and locate other major investment opportunities for iron ore projects in Australia.

It is interesting that, despite all of the published reports on Chinese investment in the Australian resources industry, only three of Chinese investments in Australia have substantial sales of iron ore to China. They include the Channar Joint Venture which was China's first overseas investment and which was formally initiated by correspondence from Sir Roderick Carnegie, who was then Chairman and CEO of CRA, to the Chinese Premier Zhou Ziyang in 1983.

Bob Hawke also played a key role in securing this Chinese investment when he became Prime Minister at that time.

The Channar Joint Venture followed the "open door" policy introduced by the Chinese leader, Deng Xiaoping in December 1978. Bob Hawke makes speeches that this was the single most important decision in the 20th Century when China opened up to the world.

The profits in 2010 from Channar were more than twice its original Capex. The Channar Joint Venture exports annually 11 million tonnes, and has recently been extended for a further 5 year period to take its total exports to 250 million tonnes.

Another is the Wheelara Joint Venture with BHP and four of China's biggest steel mills, which exports 12 million tonnes a year. I have been the lawyer for the Chinese side on both of these projects.

The third project is the Eastern Ranges Joint Venture between Rio Tinto and BaoSteel, which exports 12 million tonnes per annum.

All of the other invested projects with China are still exporting only nominal tonnages, or are still under development.

Most of China's current investment is focused on magnetite rather than hematite iron ore. Currently, however, no magnetite is being exported from Australia. All of these magnetite projects are also either still in the exploration phase or are undergoing development, but all have infrastructure constraints which will require considerable additional investment.

One leading example is the $5 billion Oakajee Port and Rail Project in the mid-West region of Western Australia, which is well behind schedule but is needed to service around 10 Chinese owned mining projects.

Australian Government's Foreign Investment Policy

Chinese investment in Australia has suffered from uncertainty and confusion from the Australian Government's Foreign Investment Policy.

When the Rudd Government first came to office, Chinese foreign investment approvals hit a period when the system simply blocked up. Chinalco got approval to make its initial investment in Rio Tinto within weeks of the election, and seemingly before the government got itself into office.

Thereafter, application after application was simply put on hold. The Treasurer Mr Swan introduced new guidelines for Chinese government in Australia which did not do much to clarify the position.

The rule was, and remains, that all Chinese government investment in resources in Australia must be notified to the Foreign Investment Review Board for approval by the Australian Treasurer.

The Australian Government's public statements claim that only two applications have been blocked on national interest grounds. However, they do not include those applications which were withdrawn, especially because the conditions imposed were not acceptable. I have Chinese clients which fall under that category.

The failure of the Foreign Investment Review Board to approval Chinalco's bid for Rio Tinto is quoted most often in China as Chinese concerns about Australian government policy on Chinese investment. Ultimately, Chinalco's bid was rejected by Rio Tinto, so that the FIRB was not required to make a decision, even after many months of delay. BHP's CEO Marius Kloppers has been quoted claiming a role in successfully encouraging the Australian Government not to approve the Chinalco bid. The fact that BHP entered into merger negotiations with Rio Tinto straight after the Chinalco bid was withdrawn upset the Chinese even more.

Recently, WikiLeaks quoted Patrick Colmer, the Head of the FIRB Secretariat, telling the US Ambassador to Australia that the Australian government wanted to restrict Chinese investment in Australia. I see that Patrick left the FIRB several weeks ago.

However, in practice, FIRB applications for China are now getting through without much difficulty. I put the timing for the change to the visit by the Chinese Vice Premier Li Kequiang to Australia in September 2009, which seemed to do much to improve the relations between China and Australia, and especially on investment.

Most recently, Chinese concerns are more focused on the Mineral Resource Rent Tax and the implications that has for China's developing projects in Australia.

Australia/China Relations Generally

Finally, a general comment on Australia/China relations generally

When Mr Rudd became Prime Minster, this was widely publicised in China. Travelling around China at the time, even in small villages, local officials all seemed to know that

Australia's new Prime Minister, called Lu Kewen in Chinese, was the first foreign leader to speak Chinese. Mr Rudd took advantage of his new status, but when he was given the privilege by the Chinese government to address students at China's leading Peking University, he criticised Chinese Tibetan policy, which greatly upset the Chinese leadership. His intemperate remarks, and his expletives about the Chinese at Copenhagen, were also widely noted by the Chinese. Last week at a private dinner in Beijing with the former Chinese Ambassador to the United States, the Ambassador raised WikiLeak reports of Mr Rudd's talks with the US that they should somehow be prepared in the future to "hit" China. The fact that the Chinese remark on these kinds of things at all shows their significance.

Despite all this, China clearly continues to view Australia as the preferred destination for investment and trade in our commodities. The next generation of leaders have all visited Australia recently, and more high level visits will occur this year. The opportunities are for ours to lose.

R H CHAMBERS