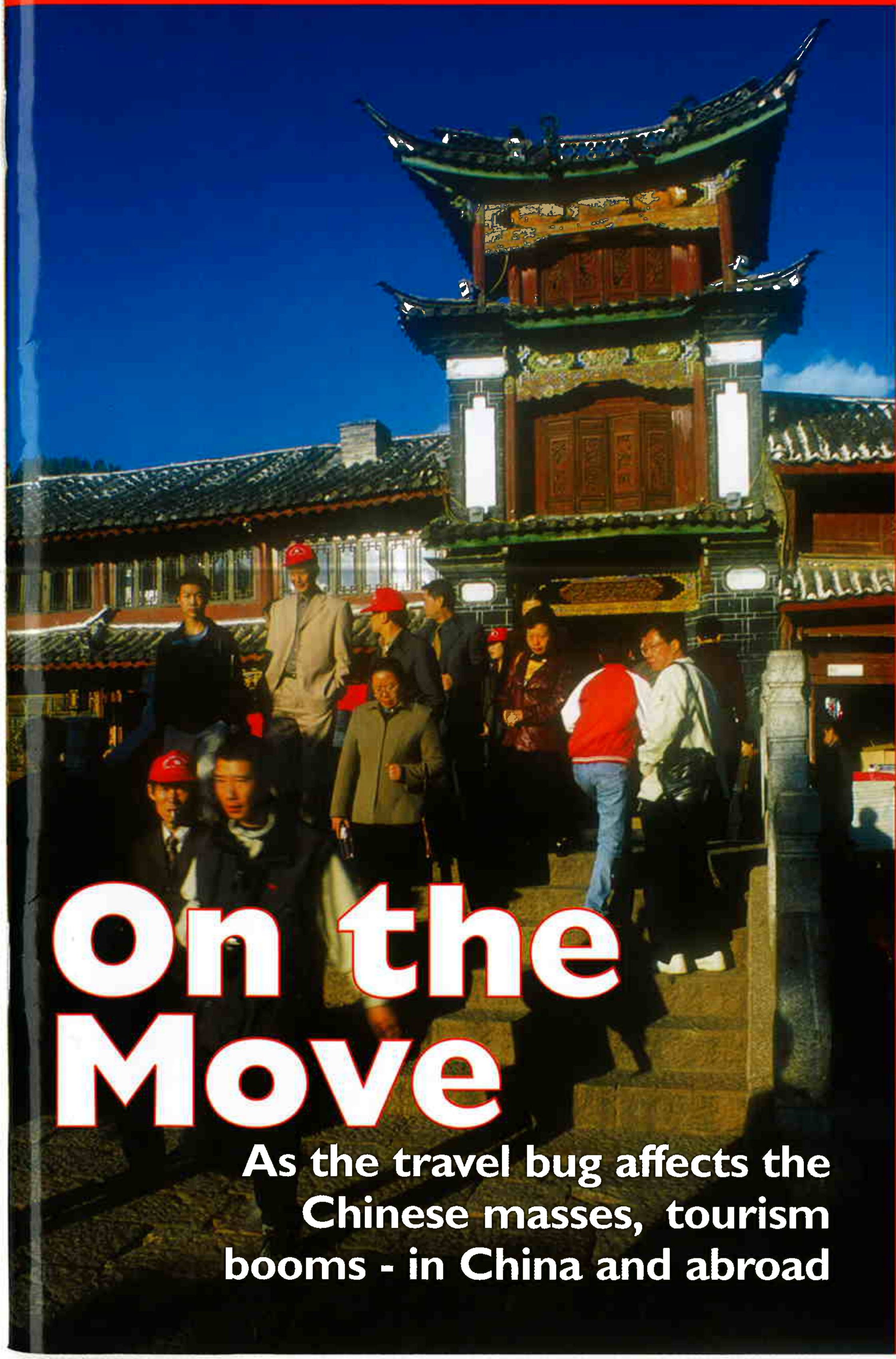
CHINA CONNECTIONS

Linking Australia with China Business 中国

APRIL-MAY 2004



On the Move

As the travel bug affects the Chinese masses, tourism booms - in China and abroad

- Hong Kong business section
- Olympic Games update
- China's impact on the world of steel
- Wealth management industry in China
- Chinese stock market primed for growth
- Ambassador Wu reflects on Australia-China relations
- Investment zone changes

Official journal of the Australia China Business Council

CHINA'S IMPACT ON THE WORLD OF STEEL

Robin H. Chambers
Senior Partner
Chambers & Company International Lawyers

China's new market domination

China is now the biggest steel market in the world and in 2003 became the biggest importer of iron ore, outstripping Japan for the first time.

China crude steel production in 2003 was around 200 million tonnes, with some predicting it will reach 250 million tonnes in 2005 and 300 million by 2010. China's iron ore imports in 2003 were around 150 million tonnes and are expected to exceed 200 million tonnes in 2004.

While these statistics are impressive, it is the future trend which is most remarkable. The Chinese steel industry became the world's largest steel industry faster than all earlier predictions and demand is expected to soar over the next decade.

China's demand for imported iron ore is having a massive impact on the structuring and investment by iron ore producers across the globe.

A background to China's steel industry expansion

The shortfall in China's crude steel production is being met by steel imports. China's demand for steel consumption in 2002 exceeded 200 million tonnes for the first time in China's history, and reached 215 million tonnes in 2003. The demand for steel has more than quadrupled since 1990. China's consumption of steel production is predicted to exceed 250 million tonnes in 2005 and 300 million tonnes by 2010. Last year, China used 36 per cent of the world's steel production and consumption is expected to rise 13 per cent this year.

The steel sector has added growth momentum to the Chinese national economy and is expected to sustain a period of rapid development although there is some concern that the breakneck expansion of production capacity will undermine the sustainable development of the steel industry as well as the overall economy.

China's own iron ore production is declining

China's own domestic iron ore production in 2002 was 231.4 million tonnes, which is a substantial shortfall against its annual requirements.

To put the total of 150 million tonnes of imported iron ore in 2003 into context, China's imports for 2000 were 60 million tonnes, for 2001 were 92.3 million tonnes and for 2002 were 111.5 million tonnes.

That massive increase took the world's iron and steel industry by surprise. In the corresponding period, China's domestic production of iron ore was down by 11 per cent. China's own iron ore mines are underground and produce low quality ore, while the major overseas mines are open-cut and produce high grade ore.

Domestic iron ore production cannot keep up with the demands of the steel industry, which has forced the Chinese steel mills to look to imports for security of supply. Moveover, domestic production has difficulty in competing with imported ore. Generally speaking, Chinese iron ore mines were developed earlier than the most efficient mines in Australia and Brazil, and have less efficient technology, are overstaffed, are burdened with social liabilities and have very low production rates.

China's impact on world iron ore industry

The excessive demand for imported iron ore from China has brought about major pressure on the major iron ore producers internationally, which have struggled in the short term to meet the rapidly growing demands in China. This has produced a global reassessment of the world's iron ore industry. The implications of that record demand will extend across the whole industry.

The largest production increases will come from Australia (with virtually all export production coming from the state of Western Australia) and Brazil, the traditional sources. Australia and Brazil continue to dominate world sea-borne trade. Australia and Brazil are the largest exporters to China, with Australia contributing more than 60 per cent of the total imports in 2003. Exports from other countries such as India, South Africa and Russia have also increased significantly in the past year or two.

Both Australia and Brazil have huge iron ore resources. Both have developed some of the largest iron ore mines in the world and benefit from the resultant low production costs. Consolidation of ownership in both countries over the past two to three years has also contributed to greater efficiency and profitability.

Total iron ore production in Western Australia in 2003 was 207 million tonnes. Planned expansion in Western Australia is for production levels to reach 260 million tonnes over a four- to five-year period, although that figure could be conservative. By the end of 2004, Australia's two largest producers, Rio Tinto and BHP Billiton will be exporting close to 200 million tonnes of iron ore to China, Japan and Europe.

The Australian iron ore industry is undergoing major restructuring and repositioning in its relationships, especially with China, in order to take advantage of the seemingly endless demands predicted for the Chinese market.

Demand from China has moved the global steel industry into overdrive.

In 1987, Hamersley Iron entered into the Channar Joint Venture with the former Ministry of Metallurgical Industry to produce 10 million tonnes a year of high grade iron ore from the Channar mine, near Paraburdoo in the Pilbara region of Western Australia. The Channar Joint Venture is recognised as China's first major overseas investment.

Hamersley Iron has previously signed up Capital Steel (Shougang) as an investor in its Hismelt direct iron making operation located at Kwinana in Western Australia, and has reportedly signed a second major steel mill for that project.

BHP Billiton and CVRD, among others, have their own strategies for developing special relationships with the Chinese steel mills to entrench supply contracts for medium- and long-term sales.

The major West Australian miners have integrated their mining operations into single, flexible mining operating units which have resulted in significant reductions in costs.

Pricing in the World Iron Ore Trade

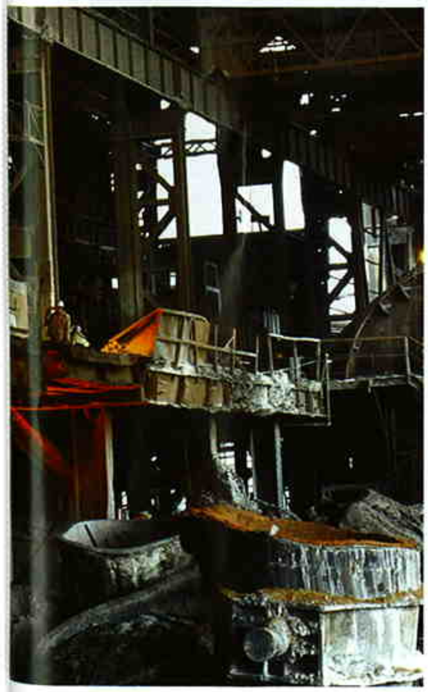
Most iron ore prices are set annually under medium- to long-term contacts, principally influenced by demand/supply factors and the forecasts for the steel industry at the time of the negotiations. For China, the pricing for iron ore has been typically based on the Japanese steel mill price. That is the result of annual, often drawn-out negotiations between a designated world producer and the Japanese steel mills which negotiate collectively.

The most recent pricing negotiations have produced prices of US$35.99 a tonne for high grade fines and US$45.93 a tonne for high grade lump.

Until this year, the Chinese market was distorted by various discounts, commissions, rebates and the like, all of which were settled to produce lower prices for iron ore in the Chinese market. Even as recently as last year, these factors were prevalent in the Chinese market, but this year as producers face unsatisfied demand from the Chinese steel mills, these features have disappeared.

It will be interesting to see how long the Japanese steel mill pricing benchmark remains the industry standard for China and Asia, given China's emergence as the world market leader for imports.

The Japanese steel mills have managed to collaborate successfully over many years in the annual pricing negotiations, and have played the various international producers off against each other to ensure the pricing negotiations are hard fought and favourable.



The Chinese industry has undergone a different transformation. This has produced a number of major steel conglomerates in China which have reached world scale, although the largest, Baosteel, is still smaller than the largest foreign producers.

In conclusion, as a lawyer involved over many years in the iron and steel industry, I am being approached by a number of Chinese enterprises, both state-owned and private, which are looking for joint venture opportunities in Australia. This has reached a new level of intensity this year. However, with the consolidation of ownership into the hands of the two major groups in Australia, the opportunities for new joint ventures have become more limited. ★★

Resources news briefs

Bluescope Steel expands in China

China has become Bluescope Steel's largest offshore investment centre, to the tune of around US$300 million, following the takeover of NYSE-listed pre-fabricated engineer, Butler Manufacturing, together with the US$220 million construction of a metallic coating and painting plant in eastern China's city of Suzhou, Jiangsu Province.

Further exploration for Sino Gold

Sino Gold gains further exploration ground in the vicinity of its "company-making" Jinfeng deposit in southern China's Guizhou Province.

BHP Billiton's Wheelarra deal

BHP Billiton signed US $9 billion 25-year iron ore supply joint venture with four of China's leading steel mills on March 1, to be called Wheelarra. Wugang is China's third largest steel maker (8.43 mln tons); Tanggang is China's sixth largest steel maker (6.08 mln tons); Magang is China's seventh largest steel maker (6.06 mln tons); while Shagang is China's thirteenth largest steel maker (5.02 mln tons).

Gold tax to be scraped

As part of moves to further develop China's gold market, China's State Council is considering scrapping the 5% consumption tax on gold jewelry, reduced from 10% in 1994, following its introduction in 1993.

Baosteel negotiations for BHP Billiton

BHP Billiton concluded iron ore price negotiations with Baosteel, on behalf of all Chinese customers, for the contract year commencing April 1, 2004. Baosteel will pay USD 0.4593 per dry metric ton unit for Mt Newman High grade lump and USD 0.3599 per dry metric ton unit for Mt Newman high grade fines, both increasing 18.62% in price year-on-year, the largest price increase for 24 years and well above analyst expectations of around a 12% rise. Rio Tinto received the same percentage rise for its iron ore supply contracts.

Power bills likely to rise

With huge power shortages affecting China, further power bill increases could be on their way to fund power grid infrastructure expansion.